EMPLOYER-SPONSORED RETIREE HEALTH INSURANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

SEPTEMBER 15, 1988

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EMPLOYER-SPONSORED RETIREE HEALTH INSURANCE

THURSDAY, SEPTEMBER 15, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
THURSDAY, SEPTEMBER 8, 1988

PRESS RELEASE #26
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U. S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON EMPLOYER-SPONSORED RETIREE HEALTH INSURANCE

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on employer-sponsored retiree health insurance. The hearing will be held on Thursday, September 15, 1988, beginning at 9:30 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.

The Subcommittee will receive testimony from the U. S. General Accounting Office and the Financial Accounting Standards Board. In addition, the Subcommittee will receive testimony from invited witnesses representing accountants, businesses, benefit consultants, insurance providers, and retirees.

The Subcommittee will consider: (1) the availability of employer-sponsored health insurance; (2) the liability associated with existing retiree health benefits; and, (3) the factors impacting on the continued availability of retiree health benefits, including increasing longevity, escalating health care costs, and applicable Financial Accounting Standards Board rules. In addition, the Subcommittee will review what steps, if any, the Federal government should take to improve the funding, availability and security of retiree health benefits.

In announcing the hearing, Chairman Pickle made the following statement: "Perhaps the greatest single uncertainty facing older Americans is the availability of affordable health care. For millions of workers, this basic need is currently being met, in part, by employer-sponsored retiree health insurance. However, as the American society and its work force ages, business and government will be forced to make hard decisions about how to provide affordable health care. In this hearing, the Subcommittee will begin to consider what role employer-sponsored retiree health benefits will play in the future. In addition, we will consider what role, if any, the Federal government should play in ensuring that these benefits are broadly available, and securely funded, so that future retirees might reasonably rely on them."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by close of business, Friday, October 7, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The Chair will ask the subcommittee to come to order, and we ask our guests, if you would please take your seats so that we might proceed.

This morning, the Subcommittee on Oversight will hold our first hearing to review the role of employer-sponsored health insurance in meeting our country's health care needs.

I believe that it is high time for us to begin this task. All across the country employers have made retiree health promises to their employees which will cost their companies billions of dollars. Yet these promises, which affect the retirement security of millions of workers, are almost completely unfunded. In many ways, the impending crisis involving retiree health plans is more troubling than that which we faced with pension plans prior to the passage of the Employee Retirement Income Security Act of 1974.

As always, many issues will have to be settled before a final solution can be reached. At this time, we don't even know for certain the total value of the retiree health promises which employers have made to their workers. The accounting profession is still wrestling with how these liabilities should be reported. Companies offering such benefits are reviewing their own plans and needs. Workers are trying to determine how their need for retiree health benefits compares with their need for current income and other employee benefits. And of course underlying all of this is the question: How can we best meet the overall health care needs of our retirees in an affordable manner?

I do not expect to find easy answers to these problems, but, in my view, retiree health benefits are equally as important as long-term health care needs. I believe that the resolution of these questions will have an impact on the retirement security of the American worker that will rival that of the Social Security Amendments of 1983.

A great deal of thought, research, negotiation, and just plain hard work lies before us. Because the stakes are high, some will be tempted to protect their own interests. I would caution them that there can be no special winners or losers on this matter. A fair answer will require all to contribute. Before we are through we will have taken a little hide and hair from everybody. I do not know what approach we should take, but with every passing day the stakes grow larger, and so, I say let us take the bull by the horns and proceed.

Before we proceed, however, I would like to yield to Mr. Schulze for any preliminary statement he would want to make.

Mr. SCHULZE. Mr. Chairman, I thank you. I am looking forward to joining you in opening our hearing on employer-sponsored retiree health benefits.

Retiree health benefits are at the same stage of evolution that pension benefits were about 25 years ago. There is no legal obligation for employers to provide health benefits either for their active or retired employees. As a practical matter, however, many responsible employers do provide health benefits.

Comparing the features of health benefit plans to pension plans is helpful, but there are significant differences. Retiree health plans often are more generous than any pension plan. At the same time, however, the employee usually has limited eligibility rights.

For example, retiree health plans often provide automatic full indexing for increases in medical costs. Next, there is no linkage between the benefits and years of service.

Finally, there is no actuarial reduction in benefits for early retirement or spousal coverage.

On the negative side, there is no vesting concept for retiree health benefits. A person must retire from his job in order to be eligible for health benefits. This means that a person who terminates employment before retirement might be vested in the company pension plan but have no rights to health benefits.

Many years ago, health insurance was considered to be an incidental fringe benefit voluntarily provided by the employer, but today, most persons think of health insurance as a form of compensation. In this context, retiree health benefits may be viewed as deferred compensation in the same way that pension benefits are viewed as deferred compensation.

Historically, retiree health benefits evolved when employers provided retirees with the same health benefits they received as active workers. It was a time when medical costs seemed under control and there were few retirees.

Thus, while retiree health benefits may have evolved in a casual, almost haphazard way, they have become a valuable retirement benefit, and not just an incidental fringe benefit. Several factors will escalate the cost of retiree health benefits in the coming generation. First, an employee's early retirement often costs an employer more than twice the amount it costs for an employee who works till age 65. This is because persons under age 65 are not eligible for Medicare. Next, the aging of the population and the increase in life expectancies both will increase the exposure of retiree health plans.

I have seen news articles with increasing frequency, which discuss the retiree health issue with a sense of alarm. Crisis-type headlines may attract more attention but they don't necessarily shed any more light on the situation.

Mr. Chairman, the retiree health issue is complex and sensitive. Our first objective should be to identify the major elements in the landscape of retiree health. From there, we can begin to explore the need to develop policy changes which might be desirable.

Today's hearing is not really intended to provide final answers to the retiree health situation, but it should help us ask the right questions in analyzing the future of retiree health benefits.

Mr. Chairman, I look forward, eagerly, to hearing today's witnesses. Thank you.

Chairman PICKLE. Our first scheduled witness—do any other members of the subcommittee want to make an opening statement? Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Let me congratulate you and our ranking member, Mr. Schulze, for bringing up this very important topic.

Before we end the 100th Congress, I believe this issue needs attention. It is an area that is of great interest to our elderly population and our employees out there now who are contemplating retirement.

I believe it is an area that needs to be addressed, it is something that we need to hear about, and I congratulate you for bringing together the witnesses today to give us a head start on this for the 101st Congress.

Chairman PICKLE. Well, I thank you, Mr. McGrath, and I assure you that Mr. Schulze and I both share the same general feelings. I also would make an observation, that our colleagues, Mr. Chandler and Mr. Flippo, both have introduced legislation and have been very active in this field. I thank them for their leadership and I know that we are going to have their full cooperation as we proceed in this area.

Now the first scheduled witness is Mr. Lawrence Thompson from the General Accounting Office. Before we recognize him, however, I believe that our colleague, Mr. Daub, would like to make a preliminary statement.

So Mr. Daub, if you will, we would be pleased to have your statement, it will be printed in its entirety, and recognize you for any other additional comments at this time.

STATEMENT OF HON. HAL DAUB, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. DAUB. Mr. Chairman, I am pleased to have this chance. I appreciate the indulgence of the committee.

I am going to be leaving, as my colleagues know, at the end of this year, but this is probably the most important subject that I can think of for yeoman work next year.

I had the chance, before I came to Congress, to manage 54 private pension plans and to work with a series of fixed and defined plans, and to spend a good deal of time in the ERISA area. I really think that damage has been done over the last 8 years, perhaps not so much damage here as the change in the business climate and the way in which overhead is managed for employee benefits, have caused sort of a standstill in the use of available tools to provide employee security. Particularly what I refer to as postretirement health as well as the conventionally defined retirement benefit. And so I would like to just spend 4 or 5 minutes, if I may, Mr. Chairman, and outline for the committee, and for the record, some things that I hope you will take a look at next year.

I want to commend you for your interest in it, and as was just said by our last colleague, the opportunity to lay the groundwork for some real action in this particular subject area is appreciated by everyone.

It is my belief that we must offer incentives to prefund retirement health benefits, and we should do it by encouraging prefunding with the tax code, much as we have pension plans. There are several bills now in Congress designed to do just that, including H.R. 2860, introduced by Mr. Chandler, and H.R. 1660, introduced by Mr. Rowland. I personally have been active in encouraging the private purchase of health insurance, including H.R. 3065, a bill to permit the full deduction for health insurance by the self-employed. I was instrumental in this fight during tax reform, and at least partially successful. I have introduced other legislation to promote the private purchase of health insurance and I continue to be

strongly opposed to the nationalization of health insurance such as the recent catastrophic health bill signed into law.

Our real problem began in 1974 when we failed to address the retiree health care liability issue in ERISA. Instead ERISA focused on making pensions secure but neglected to provide protections for health and other welfare benefits. While ERISA specifically outlines vesting and funding standards of pensions, it lacks retiree health standards.

The Deficit Reduction Act of 1984 exacerbated this problem by creating strict limits on the use of VEBAs which we would find in the code in section 501(C)(9). At one time VEBAs were the prefunding vehicle of choice. Employers could deduct contributions to VEBAs from their taxes, and interest on those contributions were tax-free. Congress changed the VEBA laws, effectively limiting their use by corporations as prefunding vehicles. Specifically an unrelated business income tax was applied to the earnings.

Another option offered by the tax law is section 401(h), exclusions to the pension trust fund. Here, employers can deduct contributions to health insurance benefits for retirees; however, employers are limited to contributing no more than 25 percent of the annual total contribution to retiree health benefits, an amount too small to cover the entire cost of the liability.

The retiree health prefunding problem was worsened by the Tax Reform Act of 1986, under a rule that disallowed a deduction for interest on policyholder loans of corporate-owned life insurance, if the loans aggregated more than $50,000 per employee. This provision imposed unnecessary limitations where such loans were used to fund retiree health benefits. You see, at the time, a few corporations were purchasing corporate-owned life insurance to prefund their retiree health benefits. The insurance was purchased and owned by the corporation, which also served as the beneficiary. Individual whole-life policies were taken out on a randomly selected representative group of employees, with their approval.

The program worked, because corporations borrowed against the cash values of the policies in order to prefund and were able to deduct the interest. Additionally, corporations received the death benefits tax-free. The employees realized that their participation would work to guarantee the payment of promises made to current and future retirees, in spite of problems other corporations had in prefunding their benefits.

I believe it is appropriate to improve incentives for employers to fund postretirement medical benefits over an employee's working career. The current pay-as-you-go funding scheme often results in less benefit protection and is erroneously based on an assumption that future medical costs will not exceed current costs.

So last December, I introduced H.R. 3778, in an effort to provide the private sector with an incentive to prefund retirement health care benefits. My legislation removes the $50,000 cap on the deductibility of policyholder loan interest where a debt is incurred solely for the prefunding of nondiscriminatory health care benefits.

My legislation would benefit the small-to-medium sized corporation, that is, the one concerned primarily with the impact to the income statement, rather than the liability on the balance sheet. And it does so with relatively little revenue cost to the Govern-

ment, $7 million—I repeat—$7 million over 4 years, because it spreads the deduction over the life of the funding plan and makes use of private-sector practices already in place.

H.R. 3778 offers a small step, albeit piecemeal, toward encouraging the adequate prefunding of postretirement medical benefits promised by employers. It is inexpensive and it works.

I introduced two other bills, Mr. Chairman, which I would also like to briefly bring to your attention.

They, too, avoid the nationalization of insurance, and instead use tax incentives to encourage the private sector to fund for long-term health care.

The first bill, H.R. 2997, would allow a person to convert tax-free, a life insurance policy surrendered in order to pay for long-term care insurance premiums. Current law would require the gain, upon the cancellation of the life policy, to be included in gross income.

My second bill, H.R. 2998, similarly allows an individual to use their IRA funds to pay for long-term health care insurance plans, without paying tax on the funds withdrawn. These are both very simple, straightforward bills, which use tax incentives to make use of programs and services already in place in the private sector. Each of these bills has about 30 cosponsors and it is my hope that the subcommittee would consider including these proposals in their package of recommendations to the full committee.

I applaud the members of the subcommittee for their attention to these very important issues, and I hope, if I can be of any service to you in this regard, that you will feel free to contact me.

Thank you, Mr. Chairman, and I thank the members of the committee.

Chairman PICKLE. Thank you, Mr. Daub, and we thank you for your interest and leadership in this area. We appreciate your statement.

Now the Chair would like to recognize Mr. Chandler who has taken a lead in this subject, and I regret that I did not recognize you before now, but Mr. Chandler, you are recognized.

Mr. CHANDLER. Thank you very much, Mr. Chairman, and I will not prolong this by making a long statement, but let me suggest to you that I believe your leadership is most enlightened. I thank you for calling this hearing.

I also want to thank my colleague, Mr. Flippo, for the work he has done and the leadership he has provided on this issue.

The health benefits for retirees, for the moment, I believe are largely secure. The courts have held that employers have to keep the promises they have made to retirees, but it is the commitments made by employers to the current workers that may be jeopardized by what we are coming to know as the FASB ruling.

Regardless of how one feels about the merits of this proposed ruling, FASB has focused attention on a terribly important issue. It was easy enough, and I would add that it was good citizenship for employers to promise retiree health benefits in the 1960's.

Health care costs then were lower, life expectancy was shorter, and there were fewer retirees. The current level of health care inflation and the sheer size of the work force that is approaching retirement will make those promises more difficult to keep.

I would like to suggest that we make a mistake, though, if all we do is focus on this single problem. In recent years, the need to raise revenue and the need to address perceived abuses has resulted in a very piecemeal approach to retirement income policy.

That may be understandable but I do not think it always makes sense. For instance, a plan sponsor sitting on a tremendous surplus in the pension plan cannot transfer the assets to a retiree health plan, but that same plan sponsor can and does use pension resources to finance corporate takeovers very much at the peril of employees.

Granted, an excise tax has to be paid if a plan is terminated in a corporate takeover, but shouldn't good public policy encourage the use of pension surpluses to meet the needs of retirees and current workers?

Or to give another example, current law provides for 5-year vesting in order to broaden pension coverage, but in an increasingly mobile work force, employees are taking lump-sum distributions as they change jobs, and they're spending them.

At retirement the money is long gone. Better pension coverage is not the result. I would like to suggest that retiree health benefits and retirement income policy are part of the same fabric.

Clearly, we must have a good health care policy because health care costs consume so much of a retiree's income, and we have to have a good income policy for the same reason.

That is why Mr. Flippo and I today are introducing a bill that attempts to address both the retiree health issue and pension policies.

Our bill would allow plan sponsors to fund retiree health accounts under current section 401(h) law. Retiree health policy can and should be coordinated with pension policy.

Our bill would allow plan sponsors to use surplus pension assets to fund retiree health benefits. In a world without a free lunch, however, our bill eliminates asset reversions. Employers would no longer be allowed to terminate pension plans and take reversions.

Surplus pension funds could be used to fund retiree health plans, or ESOPS, as provided under existing law, but plan sponsors would have to give up reversions.

If plan sponsors cannot take asset reversions, there is no need, then, for the 150 percent full-funding limit. Our bill would repeal the limitation so plan sponsors can fund heavily in profitable years as a hedge against lean years.

To make sure that retirees have the income they need to meet their out-of-pocket medical expenses, our bill attempts to broaden pension participation and to make sure that money originally set aside for retirement is actually there when an individual retires.

Under our bill, any employee whose employer does not offer a qualified pension plan would be allowed to set up a salary reduction—SEP—simplified employer plan. The employee would have to find someone to administer the SEP, a bank or a savings and loan, for instance, and the employer would be obliged to forward the employee's contribution to the institution.

Finally, in order to establish once and for all that assets accumulated on a tax-favored basis will actually provide retirement

income, the bill would prohibit distributions before retirement and would prohibit lump-sum distributions.

The money would have to be paid out in a stream of payments over the life expectancy of the retiree.

Mr. Chairman, I want to thank you, again, for conducting this hearing. I look forward to working with you on this critical issue and with my other colleagues.

As we hear what this outstanding array of witnesses has to say it will underscore the comment that you made, that this may well be as important as the Social Security issue we dealt with in 1983. I thank the chairman.

[The prepared opening statement of Mr. Chandler follows:]

OPENING STATEMENT OF HON. ROD CHANDLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

I would like to begin by thanking my chairman, the gentleman from Texas, Mr. Pickle, for calling this hearing. The subject is of great importance to the nation's retirees, and, in many respects it is even more important to current workers, as the nation's employers try to determine how to deal with a forthcoming FASB ruling that has served, in effect, as a catalyst for today's meeting.

To elaborate, the health benefits of current retirees are, for the most part, secure. The courts have held that employers have to keep the promises they've made to retirees. It is the commitments made by employers to current workers that may be jeopardized by the FASB ruling, expected next month.

FASB, of course, is the acronym for the Financial Accounting Standards Board, and when I use shorthand terms like these, I am reminded of a reaction I encountered to the way we glibly refer to the Gramm-Rudman-Hollings law.

A couple of years ago, when I was campaigning for re-election, someone in my district stopped me on the street and demanded to know, "Just who is this Graham Rudman fellow and why is he so mean?" In more recent times, when I've been dealing with reaction to the ruling we are going to be talking about today, I have occasionally wondered, "Just who is this guy Fasby? Has anybody ever seen him? And why is he so mean?" I'm sure Mr. Leinsenring and Ms. Scott will be able to help us with that.

Regardless of how one feels about the merits of the proposed ruling, FASB has focused considerable attention on a terribly important issue. It was easy enough, and I would add that it was good citizenship, for employers to promise retiree health benefits in the 1960s. Health care costs were lower, life expectancy was shorter, and there were fewer retirees. The current level of health care inflation, and the sheer size of the workforce that is approaching retirement, will make those promises more difficult to keep.

I'm not going to impose on my chairman or my colleagues by taking a lot of time to describe a proposal I've crafted to address this problem, but I'd like to suggest that we make a mistake if we fail to step back and look at this problem in a larger context.

In recent years, the need to raise revenue and the need to address perceived abuses has resulted in a rather piecemeal approach to retirement income policy. That's understandable, but the result doesn't always make sense.

For instance, a plan sponsor sitting on a tremendous surplus in a pension plan can't transfer the assets to a retiree health plan. But plan sponsors can and do use pension resources to finance corporate takeovers. Granted, an excise tax has to be paid if a plan is terminated in a corporate takeover, but shouldn't good public policy encourage the use of pension surpluses to meet the needs of retirees?

Or to give another example: Current law provides for five-year vesting in order to broaden pension coverage. But in an increasingly mobile workforce, employees are taking lump sum distributions, as they change jobs, and spending them. At retirement, the money is long gone. Better pension coverage isn't that result.

I would like to suggest that retiree health benefits and retirement income policy are part of the same fabric. Clearly, we must have a good health care policy, because health care costs consume so much of a retiree's income. And we have to have a good income policy for the same reason.

That's why Mr. Flippo and I are introducing a bill that attempts to address both retiree health and pension policy.

Our bill would allow plan sponsors to fund retiree health accounts under section 401(h). Retiree health policy can and should be coordinated with pension policy.

It would allow plan sponsors to use surplus pension assets to fund retiree health benefits.

In a world without a free lunch, our bill eliminates asset reversions. Employers would no longer be allowed to terminate pension plans and take reversions. Surplus pension funds could be used to fund retiree health plans, or ESOPs (as provided under existing law), but plan sponsors would have to give up reversions.

If plan sponsors can't take asset reversions, there's really no need for the 150% full-funding limitation. Our bill would repeal the limitation, so plan sponsors can fund heavily in profitable years as a hedge against lean years.

To make sure that retirees have the income they need to meet their out-of-pocket medical expenses, our bill attempts to broaden pension participation and to make sure money originally set aside for retirement is actually there when an individual retirees.

Under our bill, any employee whose employer doesn't offer a qualified pension plan would be allowed to set up a salary reduction SEP [Simplified Employer Plan]. The employee would have to find someone to administer the SEP, a bank or a savings and loan, for instance, and the employer would be obliged to forward the employee's contribution to the institution.

Finally, in order to establish once and for all that assets accumulated on a tax-favored basis will actually provide retirement income, the bill would prohibit distributions before retirement and would prohibit lump sum distributions. The money would have to be paid out in a stream of payments over the life expectancy of the retiree.

Mr. Chairman, I want to thank you again for conducting this hearing. I'm looking forward to working with you on this critical issue. As we hear what this outstanding array of witnesses has to say, I would encourage my subcommittee colleagues to try to focus on the big picture—an opportunity to fashion a more rational retirement income and health care policy.

Chairman PICKLE. Mr. Chandler, I think I would be remiss if I did not recognize our colleague, Mr. Flippo. We have all had our say about this preliminary approach, so, Mr. Flippo.

Mr. FLIPPO. Mr. Chairman, I will be very brief in the interest of time, but I cannot let this moment go by without thanking you very much, and Congressman Schulze, for having these hearings, and to Rod, Hal, and the other members of this committee who have had a tremendous interest in this area.

And I know of no area that will have more impact on the security of retirees, regardless of their age, than this area, and it is one that needs attention I appreciate the actions of the chairman in bringing it to all of our attention. Thank you very much.

Chairman PICKLE. Thank you, Mr. Flippo.

The committee will remember that last year, when we were considering amendments to the pension laws, that some of our members—Mr. Flippo, Mr. Chandler, and others—had recommended that we include retiree health provisions in the pension reform measure.

We felt that this was much too large a problem and program, and that money raised for the pension program is raised for pension benefits and not for health benefits. So we delayed. We refused to consider it last year, but we did promise that we would hold these hearings and get into this subject this year.

I am sorry that we were a little late in doing so, but Mr. Schulze and I wanted to get into it now, and to advance it as much as we could, and to be ready for some further serious analysis and action early next year.

Now our first witness will be Mr. Lawrence Thompson, Assistant Comptroller General of the Human Resources Program, represent-

ing the General Accounting Office, and Mr. Thompson, we are pleased that you are here, and we would like for you to proceed.

STATEMENT OF LAWRENCE H. THOMPSON, ASSISTANT COMPTROLLER GENERAL, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR FOR INCOME SECURITY

Mr. THOMPSON. Thank you, Mr. Chairman.

I have a prepared statement. I would ask that you put it in the record in its entirety, and I will just read excerpts from it.

Chairman PICKLE. Without objection.

Mr. THOMPSON. I am accompanied here by Mr. Joe Delfico, my Senior Associate Director for Income Security matters.

I am pleased to be here today to discuss our analysis of employer-provided retiree health benefits.

The private sector plays an important role in providing retirees access to affordable health care coverage. The benefits provided through company plans are especially important to retirees under the age of 65 because most are not covered by Medicare.

However, faced with increasing costs, some companies are taking action to control their current costs and limit their obligations for retiree health care benefits.

At present, retirees and active workers have limited protection from benefit modification or termination. For example, LTV attempted to terminate health benefits to over 78,000 retirees when it filed for bankruptcy in July 1986. Only congressional actions maintained their benefits.

Thus, the security of some retiree health benefits is in question. The Congress is faced with deciding whether, and to what extent, the Federal Government should get more involved.

Mr. Chairman, to help in addressing this issue, you and other members asked us to estimate companies' liabilities for current and future retirees' health benefits, assuming that companies continue to provide health care as they currently do.

Second, to estimate the annual amounts needed to advance fund these liabilities and compare them to companies' pay-as-you-go expenses.

Third, to obtain companies' views on their flexibility to change their health plans to cope with rising costs, and finally, to describe how companies are using this flexibility to make changes.

I am here today to report on our work.

We estimate that about 7 million retirees today are receiving health benefits through company plans and that companies are paying about $10 billion for these benefits.

Assuming coverage and benefit provisions do not change, we estimate that in the year 2008, these companies will be paying $25 billion in today's dollars for about 9 million retirees.

We estimate that the present value of future retiree health benefits accrued to date is $221 billion, which is about one-twelfth of the value of the stocks of American corporations in 1986.

This estimate, $221 billion, includes liabilities of $93 billion for people who are now retired, and $128 billion attributable to the

past service of people who are now working and will be retiring in the future.

Our pie chart shows accrued liabilities of $93 billion for retired workers and $128 billion for active workers.

In addition there is another amount on my chart—in fact almost as big as the two pieces that I have discussed so far—and that is an additional $181 billion which we estimate is the liability that firms will have to attribute to future work of current workers. They have not accrued it yet but they will accrue it before they retire.

When I add all those pieces together, we estimate that the liabilities of the firms for retirees and today's current workers, including both accrued and to-be-accrued liabilities, is $402 billion.

These estimates do not incorporate any adjustments that may be appropriate to reflect the passage of the Medicare Catastrophic Act in 1988.

It has long been the practice of the Financial Accounting Standards Board (FASB) to require that all material costs be disclosed on companies' accounting statements. FASB has announced it will soon be issuing proposed new rules that would require companies to disclose their retiree health liabilities.

Most companies do not advance fund their retiree health benefits but rather, pay them on a pay-as-you-go basis. New disclosure rules could prompt them to reduce or terminate their health benefits, to require retirees to pay a higher fraction of the cost of these benefits, or to start advance funding the benefits. Advance funding would provide added security for retired workers. However, at least at the outset, it would be very costly.

If employers were to start advance funding their retiree health benefits in the same way that they now fund pensions, they would contribute about $34 billion in 1988, under current coverage and benefit provisions, and under our methods and assumptions.

This is about three and a half times their current pay-as-you-go costs of $10 billion, and comes to about one-eighth of the estimated 1988 pretax profits of American corporations.

Recognizing that companies may change or terminate their retiree health plans, we asked officials at 29 companies in the Chicago area about their flexibility to change health plans to cope with rising costs, and how they are using this flexibility to make changes.

Officials at all of the companies we surveyed told us that they believed their companies have the right to modify or terminate health benefits for active workers and for retirees; 27 of these 29 companies include explicit language in their plan documents to that effect. According to company officials, concerns about rising medical costs have led 24 of them to modify their health benefits since 1984.

Officials at most of the companies told us they are committed to continue providing health benefits to their retirees but are uncertain about their companies' continued ability to pay for these benefits.

In general, company officials said they were planning to wait for the FASB to publish its proposed guidelines, and for other possible legislative and regulatory actions before deciding what additional changes are needed. They indicated that expanded tax preference

would provide a major incentive for advance funding their benefit payments.

Mr. Chairman, we believe that Congress should consider the desirability of legislation to preserve retiree health benefits, especially for retirees under the age of 65 who are not covered by Medicare.

In considering the type of action it might take, the Congress should be aware of some likely consequences.

For example, any broadening of tax preferences will obviously create tax losses for the Federal Treasury at a time when closing the budget deficit is both extremely difficult and very important.

Even with tax advantages, employers' higher annual contributions under advance funding could affect a company's willingness to even offer retiree health benefits.

If the Congress decides it should take steps to increase benefit security, it can consider any of a number of options, and we have characterized four basic approaches on the chart that I now have put up.

First, the Congress could apply a pension-type policy to all retiree health benefits. This approach would provide more secure health benefits for some retirees but may cause some companies to discontinue retiree benefits entirely.

In addition, the Federal Government would experience tax losses and probably have to establish additional organizational structures to administer the system.

Another option might be to give companies the choice of maintaining their retiree health plans on a pay-as-you-go basis or switch to advance funding of their liabilities within a pension-type framework.

Essentially, companies that wish to advance fund could take advantage of expanded tax preferences but would become subject to regulations and restrictions similar to those covering pension plans in return for the preferences.

A less comprehensive approach would be for the Congress to provide more incentive for companies to advance fund their retiree health liabilities on a voluntary basis, but not to impose the full pension regulations.

Under this approach, more companies may be willing to increase benefit security through advance funding, but the absence of vesting rules and other protections lower the level of security provided to individual retirees.

Under any of the above approaches the Congress could also consider adopting current proposals to let companies use excess pension assets to help fund retiree health plans.

Finally, to avoid some of the adverse effects of requiring advance funding, the Congress might consider a less ambitious tack. For example, one approach not requiring advance funding would be to require that all health plans extend coverage to retirees at group rates, the principal adopted in COBRA for the unemployed.

Under this approach, retirees would bear all of the cost of their health benefits, although payments would be at group rates which are usually lower than individual rates.

The advantage in this approach might well be that it expands the availability of retiree health coverage.

Other options have been proposed and each needs to be analyzed by the Congress in its deliberations. We would be pleased to assist you in any way that we can in your consideration of this vital issue.

Mr. Chairman, that concludes my statement and I will be happy to answer any questions you may have.

[The statement of Mr. Thompson follows:]

STATEMENT OF LAWRENCE H. THOMPSON, ASSISTANT COMPTROLLER GENERAL, HUMAN RESOURCES DIVISION, U.S. ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our analyses of employer-provided retiree health benefits.

The private sector plays an important role in providing retirees access to affordable health care coverage. Not only is the cost of medical care under group plans generally less expensive than that purchased by retirees individually, but companies often pay some or all of the costs. The benefits provided through company plans are especially important to retirees under the age of 65 because most are not covered by Medicare. In 1988, retirees under 65 comprised one-third of all retirees covered by company health plans, but received about two-thirds of the benefits.

Faced with significantly increasing costs, some companies are taking action to control their current costs and limit their obligations for retiree health care benefits. Retirees now receiving these benefits and active workers who expect to receive retiree benefits have limited protection from benefit modification or termination. For example, when LTV, one of the largest companies in the United States, filed for bankruptcy in July 1986, it attempted to terminate health benefits to over 78,000 retirees. Only congressional actions maintained their benefits.

Because the security of some retiree health benefits is in question, the Congress is faced with deciding whether and to what extent the federal government should get more involved.

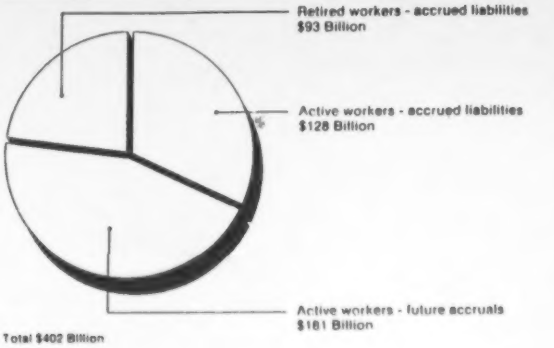
Mr. Chairman, to help in addressing this issue, you and other Members asked us to (1) estimate companies' liabilities for current and future retirees' health benefits, assuming that companies continue to provide health care as they currently do; (2) estimate the annual amounts needed to advance fund these liabilities and compare them to companies' pay-as-you-go expenses; (3) obtain companies' views on their flexibility to change their health plans to cope with rising costs, and (4) describe how companies are using this flexibility to make changes.

LIABILITIES AND ANNUAL CONTRIBUTIONS TO ADVANCE FUND EXISTING RETIREE HEALTH BENEFITS ARE LARGE

About 7 million retirees are receiving health benefits through company plans and about $10 billion will be paid by companies in 1988 for these benefits, according to our estimates. Assuming coverage and benefit provisions do not change, in 2008 these companies will pay $25 billion in today's dollars for 9 million retirees.

We estimate that the present value of future retiree health benefits accrued to date is $221 billion. This amount is about one-twelfth of the value of the stocks of American corporations ($2.6 trillion) in 1986. This estimate includes accrued liabilities of $93 billion for retirees and $128 billion attributable to the past service of active workers (see figure 1). The remaining $181 billion is for benefits that workers will earn from now until they retire. The amount the nation's private employers would need for investment today to pay future health benefits for retirees and for all covered workers in the years after they retire is $402 billion.

Figure 1: Private Companies' Estimated Retiree Health Liabilities (1988)



We did not consider employers' savings resulting from passage of the Medicare Catastrophic Coverage Act of 1988 in our estimates. Sufficient information was not available to us to determine how overall employer costs might be affected.

It has been the practice of the Financial Accounting Standards Board (FASB) to require material costs to be disclosed on a company's accounting statements to help ensure that the statements accurately represent the company's financial condition. Since 1979 disclosure of postemployment benefit costs such as those for company health care has been on the FASB's agenda. As an interim step, the FASB required current retiree health costs to be reported on companies' financial statements beginning with accounting periods after 1984.

FASB has announced its intention to issue an exposure draft that will detail its rules for recognizing and disclosing retiree health liabilities.

Most companies do not advance fund their retiree health benefits, but rather pay them on a pay-as-you-go basis. Companies and others have expressed concern that the disclosure of unfunded retiree health liabilities could adversely affect their operations, including their ability to obtain capital financing. This could prompt some companies to reduce or terminate their health benefits, require retirees to pay more of the plans' cost, or start advance funding the benefits.

Advance funding of retiree health liabilities would stabilize companies' annual expenditures. Moreover, the accumulation of assets would result in added security for retired workers. However, this would be very costly.

If employers were to start advance funding their retiree health liabilities the way they fund pensions, they would contribute $34 billion in 1988 under current coverage and benefit provisions and under our methods and assumptions[1]. This is about three and a half times their current pay-as-you-go costs of $10 billion and one-eighth of the estimated 1988 pre-tax profits of American corporations.

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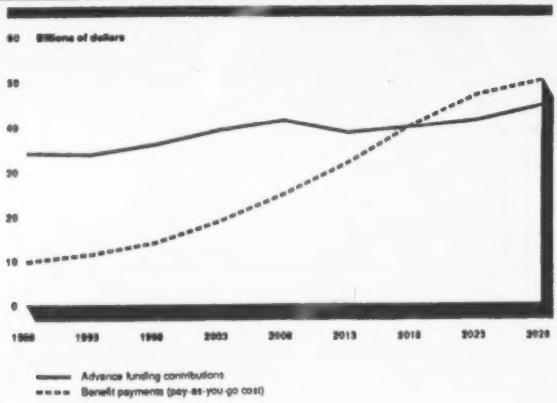
[1]We used different values for selected variables in our model to determine low and high estimates of first-year contributions and accrued liabilities. First-year contributions could range from $26 billion to $47 billion to fund accrued liabilities as low as $174 billion or as high as $295 billion, respectively.

We projected contributions and benefit payments assuming current retiree health coverage and benefit provisions do not change. As shown in figure 2, annual contributions would continue to be higher than pay-as-you-go costs in today's dollars until 2018. Thereafter, pay-as-you-go costs would exceed annual contributions. If companies wait to begin advance funding, first-year contributions will be even greater relative to pay-as-you-go costs.

Figure 2: Projected Retiree Health Benefit Payments and Contributions (1988-2028)



Note: Amounts given in 1988 dollars.

COMPANIES' CHANGES TO CONTROL THEIR HEALTH COSTS

Recognizing that companies may change or terminate their retiree health plans, we asked company officials about their flexibility to change health plans to cope with rising costs and how they are using this flexibility to make changes. We looked at the retiree health plans of 29 companies in the Chicago area. We selected a sample of companies that had plans in 1984 to determine whether they had reduced or terminated benefits since then. We also interviewed company officials to obtain their views and concerns about the security of these benefits.

Companies can control their costs, short of terminating benefits, by changing health plan provisions and cost-sharing arrangements to (1) limit the services covered; (2) restrict who's eligible to receive coverage, and for how long; and (3) require plan participants to share more of the costs. A comparison of two of the companies we surveyed shows the range of possibilities. One company allowed access to group plan coverage but did not share the costs. In 1987, this company charged retirees and their families enough in monthly contributions to fully cover plan costs. In contrast, another company, which did not require contributions, paid almost $4,000 per retiree.

Company actions to modify or terminate retiree health coverage have been challenged in court. In some cases the courts have ruled that companies may not terminate the benefits being provided persons already retired. In other cases, the courts have upheld the companies' right to modify or terminate the benefits if the companies have previously taken explicit actions to reserve this right.

Officials at all 29 of the companies we surveyed told us they believe their companies have the right to modify or terminate health benefits for active workers and retirees; 27 of the 29 include explicit language to that effect in their health plans. This is not a new development--25 already had plans with

this language at least four years ago. Since then one clarified the wording and two others added new language to this effect.

According to company officials, concerns about rising medical costs have led 24 of the companies in our survey to modify their health benefits since 1984. The modifications consisted of (1) implementing cost containment measures to help ensure that the health services provided are medically necessary and economical, (2) increasing deductibles and coinsurance payments, and (3) raising monthly contributions. These changes were directed at both active workers and retirees.

Officials at 26 of the 29 companies told us they are committed to providing health benefits to their retirees, but are uncertain about their companies' continued ability to pay for these benefits. Officials at 16 companies specifically said they were concerned about the effects of the proposed FASB disclosure requirement on their companies' reported financial condition.

Officials at 21 companies said they were considering additional changes to their retiree health plan structures. The current and future costs of providing retiree health insurance may be more than they can afford and future court rulings could reduce their ability to modify plans. Some provisicns being considered are much different from those already in place, and would result in new benefit structures. These include offering (1) health benefits that vary with length of employment, (2) defined dollar benefits that would cap annual medical payments based on years of employment, or (3) flexible compensation packages that would allow workers to choose from among a variety of pension and welfare benefits.

Company officials said they were planning to wait for FASB to publish its proposed guidelines, and for other possible legislative and regulatory actions, before deciding what additional changes are needed. They indicated that expanded tax preference would provide a major incentive for advance funding their benefit payments.

MATTERS FOR CONSIDERATION

The private sector has played an important role in providing retirees with access to company-sponsored health benefits and helping to pay for their costs. However, this role may be changing. Current and future retirees have limited protection against company actions to reduce or stop providing health benefits. In fact, to control their current and future costs, some companies are already taking action to require retirees to pay more for their medical care. Projected future costs and requirements to disclose unfunded liabilities on financial statements may increase such actions and erode retiree benefits.

We believe the Congress should consider the desirability of legislation to preserve retiree health benefits, especially for retirees under 65 who are not covered by Medicare. In considering the type of action it might take, the Congress should be aware of some likely consequences. For example, any broadening of tax preferences will obviously create tax losses for the federal treasury at a time when closing the budget deficit is both extremely difficult and very important. Even with the tax advantages, employers' higher annual contributions under advance funding could affect companies' willingness to offer retiree health benefits.

If the Congress decides it should take steps to increase benefit security, it can consider actions ranging from (1) applying pension policies to retiree health benefits to (2) requiring companies with health plans to allow their pre-65 retirees to purchase coverage at group rates similar to the coverage now provided terminated employees.

To apply pension-type policies to retiree health benefits, the Congress, among other things, will need to (1) define vested benefits, (2) expand tax preferences for advance funding, (3) develop funding standards, and (4) consider establishing an insurance program similar to the one administered by the Pension Benefit Guaranty Corporation. This approach would provide more secure health benefits for some retirees, but may cause some companies to discontinue retiree benefits for others. In addition, the federal government may have to establish additional organizational structures to administer the system.

Another option would be to give companies the choice of maintaining their retiree health plans on a pay-as-you-go basis or advance funding their liabilities within a pension-type framework. Companies that wished to advance fund could take advantage of expanded tax preferences, but would become subject to regulations and restrictions similar to those covering pension plans. Companies that did not want to be subject to pension-type regulations could maintain their pay-as-you-go plans if they desired. Under this option, the benefits of some current and future retirees would be more secure than others.

A less comprehensive approach would be for the Congress to provide more incentives for companies to advance fund their retiree health liabilities on a voluntary basis, but not to impose the full pension regulations. Standards for advance funding and the distribution of plan assets in events such as plan termination would need to be established. This approach lessens burdens on companies but also does less to promote the security of these benefits. Under this approach more companies may be willing to increase benefit security through advance funding, but the absence of vesting rules and other protections lower the level of security provided individual retirees.

Under any of the above approaches, the Congress could also consider adopting current legislative proposals to let companies use excess pension assets to help advance fund retiree health plans.

To avoid some of the adverse effects of requiring advance funding, the Congress might take a less ambitious tack. For example, one approach not requiring advance funding would be to require all health plans to extend coverage to retirees at group rates. Under this approach, retirees would bear all of the cost of their health benefits, although payments would be at group rates which are usually lower than individual rates. An advantage is that this approach might well expand the availability of retiree health coverage.

Other options have been proposed and each needs to be analyzed by the Congress in its deliberations. We would be pleased to assist you in your consideration of this vital issue.

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Mr. Chairman, this concludes my statement. I would be happy to answer any questions at this time.

OBJECTIVES, SCOPE, AND METHODOLOGY

To prepare our estimates of companies' total and accrued liabilities, we updated and expanded an economic model used by the Department of Labor in a 1986 report on employer-sponsored retiree health insurance. Total liabilities--the present value of future benefits--represent the amount of money one would need to have available for investment to provide currently covered workers and retirees with retiree health benefits. If these benefits were advance funded and assumed to be earned over workers' careers, the accrued liabilities would be the portion of total liabilities assigned to workers' and retirees' past years of employment.

To make our calculations, we made several simplifying assumptions. For example, we based our model on our own and others' estimates of average national retiree health costs and of the number of current and future workers covered by employer-provided retiree health plans. We assumed current levels of coverage and benefit provisions would continue, even though companies can modify or cancel their plans. We treated the 1988 accrued liabilities as unfunded, even though we know a few firms are currently funding these liabilities in advance. Finally, we used a projected unit credit funding method with accruals for service after age 40 and no terminations other than death.

For specific model parameters, we analyzed data on numbers of active workers and retirees with retiree health benefit coverage, health care costs, rates of retirement, life expectancy and interest rates, and we reviewed available studies of retiree health costs. Because precise, up-to-date information does not exist for many of the factors affecting companies' total liabilities and annual contributions, we performed sensitivity analyses of our liability estimates by varying our coverage, retirement, mortality, and inflation assumptions.

To estimate the contributions companies would have to make to start advance funding their liabilities in 1988, we used a closed group of workers and retirees. Our estimates of benefit payout and advance funding contributions in 2008 were based on an open group valuation allowing for new entrants through the year 2032. Annual contributions include an amount to cover accruals for active workers as well as a 25-year amortization payment on initial (unfunded) accrued liabilities.

To assess companies' flexibility to modify retiree health plans and examine recent changes companies have made in these plans, we surveyed 29 medium and large companies with retiree health plans in the Chicago, Illinois, area. These companies had from 186 to over 50,000 active workers; the number of retirees ranged from 12 to 39,000. We also met with company officials and other experts and reviewed recent public- and private-sector studies and court decisions to better understand the kinds of changes that companies were making. Our findings on specific changes cannot be generalized beyond the 29 plans we surveyed.

Chairman PICKLE. Well I thank you, Mr. Thompson, and I want to thank you for a good strong statement.

I am pleased that you would make it. Quite often, when we ask GAO to make a report they come to us with an "if" or an "on the other hand," and just make an analysis and not much more.

You have ventured to give us some options, and while I would hasten to say I do not know that we are going to adopt any one of your options, they are points that we should take into consideration.

I think that in this particular instance, at least, GAO has given us something to think about.

You have thought about this, and have made some specific recommendations. So I thank you for that.

I also noted, just parenthetically, that when you got to one of the options, you said that "In any of the above approaches the Congress could consider using the excess pension assets," and you said that in such a soft voice, and your voice trailed off, that I did not think you had much force behind that statement.

I do not know whether that was intentional or not, but I noticed it.

Now, Mr. Thompson, let me get back to what I think that I want to get from you.

You were asked to give us an estimate of the corporate liabilities of these pension funds, and you arrived at a figure of $402 billion.

I would like for you to tell me again how you arrived at that sum, just so that the audience can hear it, other than your written statement. And I have a question, too, about that.

What I want to know is what is the liability out there now, for the retiree health plans? So give us again, once more, an explanation of how you arrived at the $402 billion figure.

Incidentally, we have heard that the figures might be $200 or $400 billion, and they go as much as $2 trillion. That is a big gap in there. So, if it is at least that much, as you say, it could even be more.

But tell us, once more, how you arrive at it.

Mr. THOMPSON. We arrived at our estimate by looking at data on how many people have benefits and what the average benefits cost, and making plausible assumptions about what will happen in the future to medical costs.

That is how we did it. I think it is important to try to understand the components of this estimate because various people come up and throw around numbers which perhaps are similar to ours, but they are only talking about one piece of it.

Let me underscore that the liabilities we are measuring are the present value of the future liabilities. You could think of that as the amount of money the employers have to stick in the bank today so that they will be able to pay these liabilities off as they become due.

We divided these liabilities into three parts. For the first part, we thought of the folks who are already retired: What would you have to put in the bank to have enough money to pay their medical costs under the health plans as they now exist? We calculated that to be $93 billion.

For the second part, we thought of the process by which employees accrue rights to these benefits over their working careers—although the process does not quite work that way right now. Then we looked at how many active workers accrued rights to benefits already, and we asked how much would it cost when they retire? Although these workers are still active workers, they will collect benefits when they retire if their plans continue to exist as they do now.

We asked what would the accrued liability for active workers be? We calculated it to be $128 billion. Together, accrued liabilities for retirees and active workers were $221 billion.

It is our understanding that when the FASB talks about asking corporations to show their future liabilities on balance sheets or on their financial statements, that their current thinking is they are asking them to show accrued liabilities.

The number that we are talking about for each corporation is essentially the concept that leads to $221 billion for the whole economy.

For the third part, the remaining $181 billion are liabilities for future benefits that current workers will be earning as they continue working.

Does that answer your question, sir?

Chairman PICKLE. Now Mr. Thompson, how many companies did you survey?

Mr. THOMPSON. Well, there are two parts to this.

Our estimates of the liabilities are based upon data sets that surveyed hundreds and thousands of companies, from the Bureau of Labor Statistics, and so forth.

Chairman PICKLE. Around 2000, did you say? How many companies over the country—I notice you surveyed some 29 in the Chicago area. Did you go to Dallas? Did you go to San Francisco?

Mr. THOMPSON. Oh, yes.

Chairman PICKLE. Did you go to New York?

Mr. THOMPSON. The estimates of the liabilities are based on nationwide data.

For the second part, we talked to plan managers in the Chicago area, just about 30, to get an indepth idea of their thoughts.

Chairman PICKLE. Well, then, you're comfortable in saying that your survey was a nationwide survey?

Mr. THOMPSON. I am comfortable that the liability estimates we have are based on valid nationwide data.

Chairman PICKLE. Now you are saying that this $402 billion is the amount, then, that employers would have to pay, or make as an investment, if they are going to pay for the value of the health plans of both present retirees and future retirees, and it would amount to as much as $402 billion.

Now are you comfortable with that figure? Some have said it might be as much as $2 trillion. Could that be so?

Mr. THOMPSON. We could not find a way to justify a figure that high.

Chairman PICKLE. But you are comfortable, at least, with the $402 billion?

Mr. THOMPSON. We are comfortable with the $400 billion. Yes, sir.

Chairman PICKLE. All right. I would guess one of the statements you made, that impressed me, was you said the first question we would have to ask is, Does the Federal Government feel it should, and to what extent, get involved in this question. And I guess that is the first question we have to ask.

I am going to ask the FASB people the same question, but I will ask you: When a worker is promised his health retiree benefits, is it a promise that the company feels they can give or take as they wish?

Does your survey give any indication, from the companies involved, that they feel that they could cancel this health retiree promise any time they want to?

Do they feel that they have that right?

Mr. THOMPSON. They feel they have that legal right.

Chairman PICKLE. Is that in their contract with the workers?

Mr. THOMPSON. The tendency is to put it in the contract, that they have the right to terminate their health benefits.

Chairman PICKLE. Is that a verbal or a written provision?

Mr. THOMPSON. It is a written provision.

Now, I want to underscore that they tell us they do not want to have to exercise that. They feel they have a moral commitment, but——

Chairman PICKLE. In other words, the companies are saying in their contract we are going to give you the health retirement benefit but we reserve the right to cancel any time we want to?

Mr. THOMPSON. That is correct, sir.

Chairman PICKLE. And that is written in many of the contracts now?

Mr. THOMPSON. That is correct, sir.

Chairman PICKLE. Well, I am not going to ask your view of that, but that would seem, to me, an important question.

Well, I am going to stay within my time. I thank you for your comments, and we may have other questions for you.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman, and thank you, Mr. Thompson. I join the Chairman in congratulating you on a job well done.

In your survey, did you find that some economic sectors are more affected or will be more impacted than others? For example, will our aging industries be impacted more than the new high-tech industries?

Will service industries be impacted more than basic industries? Will other sectors of our economy be impacted in a greater or lesser way?

Mr. THOMPSON. Yes. There is a variation.

The incidence of retiree health benefit promises tracks very closely with who offers pensions.

Mr. SCHULZE. With what?

Mr. THOMPSON. With which firms offer pensions.

Mr. SCHULZE. I see.

Mr. THOMPSON. They tend to go hand in hand. And since the retiree health plans are unfunded, what you find is the largest liabilities are with the largest firms offering pensions, especially if they offer pensions that allow early retirement options.

That means that the incidence of these liabilities, or at least the incidence of these benefit promises that give rise to liabilities, is highest in the manufacturing area, and tends to be lower in the retail trade or service sectors of the economy.

Mr. SCHULZE. So that if we do anything, or make any decisions in this area, we have got to look at the long-range economic impact on those areas which are not now covered.

Do you have any suggestions along those lines?

Mr. THOMPSON. Well, I would urge you, as you consider this, to think of the problem having two parts.

The first part is assuring that retirees have access to group health insurance. I think that one of the most serious problems is if you retire and you lose access to the employer's health insurance plan, and you are in your late fifties or early sixties, it is very difficult to get an individual health insurance policy.

You may not be insurable. If you are insurable, you may not be covered for any preexisting conditions, and you are liable to pay, under the best of circumstances, maybe 25 percent more than you would under employer sponsored group health insurance.

Mr. SCHULZE. Should there be industrywide retiree health benefit plans, or should they be commingled with the active workers?

Mr. THOMPSON. I am not prepared to answer that kind of a question.

I think what you are hinting at is there are a lot of options here.

Mr. SCHULZE. Enormous numbers.

Mr. THOMPSON. The first thing I would like to leave you with is that access to some sort of group health insurance is very important. There is a second question which is who pays for it.

Retirees are a lot better off, even if they have to pay for it out of their own pocket if they just have access to something.

Mr. SCHULZE. Of the $402 billion, how much of that is covered by union contracts?

Did you take the entire retiree health family of the nation, or, did you break it down as to those mandated by union contracts, and as a consequence enforceable by the courts, versus some that were a little more vaguely worded and might not be enforceable?

Mr. THOMPSON. The activity behind me was our trying to find out the answer to that question.

Mr. DELFICO. A rough guess, in answer to that question, is that the union contracts covered about 40 percent of our sample. So that you roughly project that to the number we have been talking about.

Mr. SCHULZE. I guess any figure is necessarily vague; did you, in your model, determine the level of funding, the type of health care? Does it include full medical, dental?

Did you have any kind of a deductible, or did you take an average of the policies across the country?

Mr. THOMPSON. We took an average of costs. We used surveys that said what employers are actually paying. Built into that average is the incidence of employee contributions, of deductibles, copays, dental, the whole thing. We are basically taking an average employer cost and assuming that that will grow at the rate of medical inflation.

Mr. SCHULZE. Did you break out public sector versus private sector?

Mr. THOMPSON. These are all private sector.

Mr. SCHULZE. These are all private sector?

Mr. THOMPSON. Right.

Mr. SCHULZE. Do you have any figures at all on public sector?

Mr. THOMPSON. We do not have public sector figures.

Mr. SCHULZE. It seems to me that in the myriad of townships, boroughs, counties, police, firemen groups, military, and other groups across the country, that we have another large liability looming in the public sector.

Do you have any idea of what kind of figures we are talking about there?

Mr. THOMPSON. No, I do not, but I understand one of the later witnesses may be able to help; the Employee Benefit Research Institute.

Mr. SCHULZE. According to your figures, are large companies giving greater benefits than small companies?

Mr. THOMPSON. I am not sure I have enough information to answer that. We are taking a closer look right now at the small employers.

Mr. SCHULZE. If we take action, should we try to homogenize benefits, or should we try to stagger or stage——

Mr. THOMPSON. When we talked to the people in Chicago—and that is only one city, but we were able to get into what kind of policies companies have, we found quite a mixture. We find some employers who offer it up to age 65 and not thereafter.

We find some who offer you exactly the same deal that you got when you were a worker. We find others that drop the dental benefits or drop some of the vision benefits when you become a retiree.

We even found one that simply said to retirees this is our group policy, you can have access to it, but you must pay the entire cost.

So what we found was a wide variety of treatments, and I suppose if there is anything I should leave you with, it is that as you legislate, keep in mind that it is not a homogenous benefit.

Mr. SCHULZE. How about demographics by industry?

Without having figures, it seems to me, that if we looked at an aging industry such as steel, I would presume it has older workers versus the computer industry. If we legislated we would automatically create some kind of inequity because it would be a larger burden on those industries than it would be those who are hiring the bright young folks out of college today. It would be a longer term situation for the high-tech companies than it would be for the aging industries.

Mr. THOMPSON. Yes. To the extent that you mandate continued employer payment of a good chunk of the cost, you are going to mandate a bigger liability on the older firms.

Mr. SCHULZE. So if we do something we should certainly take a look at that and try to level that playing field?

Mr. THOMPSON. I would think so.

Mr. SCHULZE. My time has expired. Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze. The Chair recognizes Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Thompson, I find your chart very impressive, and that study showing the magnitude of that problem. Did you make any estimates about the number of workers that are covered in retiree health benefits, and those that are not?

What is the percentage of covered employees to the total population of employees? What percentage is covered by retiree health benefits?

Mr. THOMPSON. Let me tell you what I know, right away, and then turn around and see if I can get you some more information.

We are estimating that about 33 million workers are currently working for firms that offer retiree health benefits. And that would be about 40 percent of the total. Forty percent of the people are working for employers who offer these benefits.

We believe that about 80 percent of the people who are retired and are receiving pensions are also getting some form of retiree health benefits.

Did I come close to answering your question?

Mr. FLIPPO. Yes. Forty percent of the workers in the work force today are covered with retiree health benefits?

Mr. THOMPSON. That is our estimate.

Mr. FLIPPO. So 60 percent are not?

Mr. THOMPSON. That is correct, sir.

Mr. FLIPPO. If we had 100-percent coverage by these families, that figure then would be translated—do you find these employees generally higher paid, the 40 percent that are covered with these benefits? Their income levels?

Mr. THOMPSON. I do not know that we looked at that, but I think it would be fair to assume that they are because they tend to be employees of the larger firms that offer pensions, and, we know, in another context——

Mr. FLIPPO. I was just trying to look at our work force as a whole to see. We have about 60 percent, then, of our work force that are not covered with any retiree health benefits?

Mr. THOMPSON. Right.

Mr. FLIPPO. And that is other things that Government of course has to be concerned about as well.

Would you repeat what you said to me about the 80-percent figure. I am not sure I understood that.

Mr. THOMPSON. We estimate that something like 80 percent of the people who retired and are receiving pensions are getting health benefits with those pensions. About 20 percent of people who receive pensions do not. Think of a 62-year-old getting a pension. About 80 percent of those people have health benefits.

Mr. FLIPPO. That is just a monstrous figure.

In your testimony you mention that the courts, on a case by case basis, have been ruling on whether a company can limit its current retiree health liability.

Can you tell us what the general trend of the courts have been in regard to that question.

Mr. THOMPSON. Yes. It is unsettled, the state of the law, but it would appear that if you are careful about stating in your plan documents that you reserve the right to terminate these benefits, then the courts will not prevent you from so doing.

There is special legislation that has to do with companies filing for bankruptcy, but as a general proposition, that seems to be the trend now.

If you did not so specify, carefully, then the courts begin to look at what you said in writing, and what maybe was said verbally, and try to construe whether or not there is an ongoing contractual obligation.

Mr. FLIPPO. So individuals should not be assuming, or that they should be really looking very carefully at what the companies are promising?

Mr. THOMPSON. That is correct.

Mr. FLIPPO. This business of doing the right thing, then, would not be much security in old age, sometimes.

Thank you, Mr. Chairman, and thank you very much for your statement.

Chairman PICKLE. Thank you, Mr. Flippo. Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman, and thank you, Mr. Thompson, for your excellent testimony.

I want to follow up on the point that Mr. Flippo was making, a kind of a bottom line, that all of us on this committee need to understand the liability represented by your study.

The $402 billion represents retired workers, the accrued liability for active, and the future liabilities of people who are currently working.

Do we know how much of that is prefunded, where assets have been set aside to cover those benefits?

Mr. THOMPSON. We believe it is less than 2 percent. It is really a very small amount of money that has currently been set aside.

Mr. CHANDLER. Is there anything in current law, of any significance, that encourages prefunding of these retiree benefits?

Mr. THOMPSON. I think you know the answer to that as well as I do.

Mr. CHANDLER. It is no.

Mr. THOMPSON. The answer is no.

Mr. CHANDLER. Legally, then, as far as the jeopardy of workers, and the likelihood of them becoming one of those retirees with a legal right to a benefit—represented by the $93 billion, and the 7 million retirees today—would it be fair to say that the $128 billion and the $181 billion liability for current workers is, in a sense, in jeopardy?

That a company could, if pushed to the wall and faced with this tremendous liability, begin to terminate the plans represented by those larger figures?

Mr. THOMPSON. It is pretty clear that the people who have not yet retired do not have a very firm commitment to health benefits, and there are even situations where the ones who are retired may not have an ironclad commitment.

Now I think, Mr. Chairman, that is a very important point that has to be made here, that current retirees may even be in jeopardy, but certainly, as far as the benefit, funding at a 2-percent level over the $402 billion, the legal requirement—that workers expecting and planning for a retiree health benefit are, I think, on pretty shaky ground right now.

Mr. CHANDLER. You mentioned the catastrophic health insurance bill and that you had not considered that in your estimates.

Did you find, though, that many of the companies that pay a retiree health benefit either now pay part B premiums or would continue to do so with the new, higher catastrophic level, and that their agreements would anticipate paying that?

Mr. THOMPSON. I am sorry. We do not have any information with us on that, Mr. Chandler.

Mr. CHANDLER. OK. My impression is that that is probably the case, that many would. The liability probably would not be adjusted by consideration of passage of the catastrophic bill, and that is something we may want to look into, to see if that indeed is a fact.

Now one final question, Mr. Chairman, because you asked Mr. Thompson about the surplus assets.

Now I want to make sure that we, on the panel, understand this issue. Maybe your voice did trail off, but I did understand you to say that that was an option that the Congress could legitimately consider as a funding mechanism.

Am I correct?

Mr. THOMPSON. I did say that, sir.

Mr. CHANDLER. All right. The surplus assets in a pension plan today can revert to the company by one mechanism, and that is terminating a plan, is that correct?

Mr. THOMPSON. Right.

Mr. CHANDLER. And that is the only way that they can reacquire those assets?

Mr. THOMPSON. That is right.

Mr. CHANDLER. What other use of those assets can currently be made under law?

Mr. DELFICO. Mr. Chandler, that is use of the excess assets?

Mr. CHANDLER. Yes.

Mr. DELFICO. What use can be made under current law?

Mr. CHANDLER. Yes.

Mr. DELFICO. To my knowledge, I do not think anything other than a reversion.

Mr. CHANDLER. Right. Even if the Congress prohibited asset reversions what other use would be made of those assets?

Mr. DELFICO. On one hand the companies may increase benefits——

Mr. CHANDLER. But they are not required to.

Mr. DELFICO. They are not required to, but they can.

Mr. CHANDLER. The point I am trying to establish here is that those assets may well be in place, but that does not represent any liability, any commitment of any kind to workers, over and above what they have promised with their defined benefit plans.

Mr. DELFICO. That is correct.

Mr. CHANDLER. So if we were to utilize surplus assets in a pension plan to prefund a retiree health plan, we simply would be providing from a company's assets to go back.

One thing that a company could do is, in a lean year, when their profits were down, because business was poor, they could utilize that surplus to fund the current liability represented by their pension plan. That is one other use.

Mr. DELFICO. That is right.

Mr. CHANDLER. So that if we did allow the use of these surplus assets for the benefit of future retirees' retirement medical plans, that would not be a diversion of that asset to some other use other than the benefit of employees.

Would you agree to that statement?

Mr. THOMPSON. I would think that is a fair statement.

Mr. DELFICO. Yes, I would agree to that.

Mr. SCHULZE. I think that is an important point, and Mr. Chairman, one that I wanted to make. Perhaps other witnesses will agree with it in their testimony today.

Thank you, sir.

Chairman PICKLE. I thank you, Mr. Chandler.

Mr. Thompson, I thank you. Now we are going to submit additional questions in the interest of time because we have about four panels today.

We are going to proceed, but I thank you for your statement. I thank you for your positive approach to this.

We might consider certain options. I think that helps the committee. I do not know the extent to which we will follow those options, but they are helpful to us because at least you have been doing some thinking about the whole problem and we appreciate your testimony.

So thank you very much.

Mr. THOMPSON. Thank you, Mr. Chairman.

Chairman PICKLE. Now the Chair will ask Mr. James J. Leisenring, Vice Chairman of the Financial Accounting Standards Board (FASB) to take his position at the witness table.

He will be accompanied by Diana J. Scott who is Project Manager of the Financial Accounting Standards Board.

Mr. Leisenring, we are glad you are here, this committee and the Congress, and I think that business and the working world is awaiting your testimony.

I must confess, I did not know, or had not thought much about what FASB meant. I had heard about frisbees but not FASBs. All at once you have become a household word in this area of health benefits, and we are anxious now to hear what you have to say.

So we would like for you to proceed. Your entire statement will be made a part of the record and you may summarize or proceed in any manner you wish.

So we ask you to proceed. We are glad you are here also, Ms. Scott. Mr. Leisenring.

STATEMENT OF JAMES J. LEISENRING, VICE CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOMPANIED BY DIANA J. SCOTT, PROJECT MANAGER

Mr. LEISENRING. Thank you, Mr. Chairman.

As you indicated, I am Jim Leisenring. I am Vice Chairman of the Financial Accounting Standards Board, and with me is Diana Scott, the project manager on the Board's professional staff assigned to the project on employers' accounting for postretirement benefits other than pensions. We appreciate the opportunity to appear before this subcommittee and to answer your questions.

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I would like to start by briefly describing the FASB and its mission followed by a short history of our project on postretirement benefits other than pensions, and what we hope to accomplish with our proposed accounting standards: Diana will then describe to you the scope and major provisions of the accounting to be proposed for those postretirement benefits. A full description of the FASB's mission and decisionmaking process was sent to the subcommittee earlier. In addition, a more comprehensive description of the accounting issues related to postretirement benefits, other than pensions, was provided to the staff. We would be pleased to respond to questions of the subcommittee on those materials or other related matters that you deem appropriate at the conclusion of our prepared remarks.

Since 1973, the FASB or Financial Accounting Standards Board, has been the designated organization in the private sector for establishing standards of financial reporting. Those standards govern the preparation of financial reports. Pronouncements of the FASB apply to all business enterprises and are officially recognized as constituting generally accepted accounting principles by the Securities and Exchange Commission and by the American Institute of Certified Public Accountants. The term, "generally accepted accounting principles," often referred to as GAAP, describes a body of literature and accepted practice that is designed to provide relevant, reliable, and useful information to a wide group of investors, creditors, and other users of general purpose financial statements.

The FASB follows an extensive due process that is open to public observation and participation. This process was modeled on the Federal Administrative Procedure Act and in several respects is more demanding.

For each major project on our technical agenda, the Board appoints an advisory task force of outside experts and studies existing literature on the subject, and conducts or commissions such additional research as may be necessary. Typically, a discussion document is published that sets forth the issues and possible solutions as the basis for public comment, an exposure draft of the proposed statement is broadly distributed for public comment, and public hearings on the proposed accounting are conducted. The Board actively solicits the views of its various constituencies on all accounting issues.

Significant steps in the process are announced publicly and the Board's meetings are open to public observation and a public record is maintained.

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. Accounting standards are essential to the efficient functioning of the capital markets because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information. That information often results from approximate, rather than exact measures.

The Board strives to remain objective in its role as a standards setter and to ensure, to the extent possible, the neutrality of the financial information produced by the accounting process. To achieve that objective, the financial information must report eco-

nomic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

To improve the usefulness of financial reporting, the Board focuses on the characteristics of relevance and reliability. While the impact of a standard that results in relevant and reliable information may be perceived as undesirable by some interests, the price of not issuing that standard is the dissemination of less relevant and potentially misleading information which, in the long-run serves no one well. The FASB believes that its primary responsibility is the integrity of the financial reporting system. Another of the Board's objectives is to strive for accounting standards that result in similar accounting for similar transactions and circumstances. Comparable reporting by companies competing for capital clearly is in the public interest.

In 1979, the Board added other postretirement benefits to its existing agenda project on accounting for pensions. The Board was concerned about the lack of information in financial statements regarding the cost of and obligation for postretirement benefits other than pensions. Evidence suggested that most large companies and many smaller ones provided health care and life insurance benefits, as well as pension benefits, to their retired employees. The existing accounting literature covered pensions but not other postretirement benefits. As a consequence, the majority of sponsoring employers were, and still are, accounting for the cost of those other postretirement benefits on a pay-as-you-go or cash basis.

In 1982, the Board tentatively concluded that the cost of postretirement health care and life insurance benefits provided to retirees should be accrued during the service lives of the employees expected to receive benefits under those plans. The board based its tentative conclusion on its view that postretirement benefits are a form of deferred compensation. That view led to the conclusion that an employer has an obligation for promised benefits to the extent that the service required by the retirees and future retirees in exchange for those benefits has already been rendered and future payments are probable.

At the same time, the Board was considering pension issues, and found that the accounting issues related to other postretirement benefits were being overshadowed by pension issues.

Consequently, in February 1984, employers' accounting for postretirement benefits other than pensions was established as a separate project on the Board's agenda. As an interim measure, the Board issued FASB statement No. 81, "Disclosure of Postretirement Health Care and Life Insurance Benefits." That document calls for disclosure in the footnotes to the financial statements of a description of retiree health care and life insurance benefits provided, the accounting and funding policies for those benefits, and the cost of those benefits recognized for the period. Generally, as I have previously indicated, those costs are recognized on a pay-as-you-go or cash basis, not when they are earned by the employees.

The Board resumed its consideration of postretirement benefits other than pensions in 1986, after issuing its pension accounting standards. In the next few months, the Board expects to issue for comment an exposure draft of a standard on employers' accounting

for postretirement benefits. At least 180 days will be provided for interested parties to comment on the exposure draft, followed by public hearings next summer. After considering the written and oral comments, the Board expects to issue a final standard as early in 1990 as possible. The effective date for most provisions of the document is expected to be 1992, except for small employers and non-U.S. plans, for whom the proposed effective date will be 1994.

I will now ask Diana Scott to provide you with a brief description of the scope and the major provisions of the proposed accounting for postretirement benefits other than pensions.

Ms. SCOTT. Mr. Chairman, the FASB's proposed statement on employers' accounting for postretirement benefits other than pensions will establish standards of financial accounting and reporting for an employer that offers postretirement health or other welfare benefits to its employees. Postretirement benefits include all types of benefits, other than retirement income benefits, provided by an employer to retired employees, their beneficiaries and dependents. The benefits encompassed include, but are not limited to, retiree health care, which is thought to be the most significant in terms of cost and prevalence; life insurance that is provided to retirees outside a pension plan; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement.

The Board's conclusions in the proposed standard derive from the basic notion that a defined retiree welfare benefit is an exchange between the employer and the employee. In exchange for services provided by the employee, the employer promises to provide, in addition to current wages and other benefits postretirement health and other welfare benefits during the employee's retirement period. It follows from that basic view that retiree welfare benefits are not gratuities, but instead, are part of an employee's compensation for services rendered, and since payment is deferred, the benefit is a type of deferred compensation. It also follows that the employer's obligation for that compensation is incurred when the services exchanged for that benefit are rendered.

The underpinnings of the proposed standard rely on a basic premise of generally accepted accounting principles that accrual accounting provides more relevant and useful information than cash basis accounting. The importance of information about cash flows, or the funding of the plan, is not ignored. The amount funded or paid is, of course, given accounting recognition as a use of cash, but the Board believes this information about cash flows alone is not sufficient. Accrual accounting goes beyond cash transactions and attempts to recognize the financial effects of noncash transactions and events as they occur. Measurement and recognition of the accrued obligation to provide retiree welfare benefits will provide users of financial statements with the opportunity to assess the financial consequences of employers' compensation decisions.

Accrual accounting is concerned with expected future cash receipts and disbursements from transactions and events that have already occurred, and recognizes assets, liabilities, and earnings on that basis. The Board believe that for postretirement benefits other than pensions, as in other areas, the resulting accounting informa-

tion is more representationally faithful and more relevant to financial statement users than accounting information prepared solely on the basis of cash transactions.

Among the many issues considered by the Board in this project, three stand out as central to the Board's extensive deliberations and to public debate. Those issues are, first of all, whether there is an obligation that meets the definition of a liability that should be recognized in an employer's statement of financial position; secondly, how and when the obligation and the related cost should be recognized; and finally, how and when to measure and recognize the net obligation that exists at the date a final standard is initially applied, which we refer to as the transition obligation.

After considering the FASB's conceptual framework for accounting standards, the Board concluded that an employer's obligation to provide postretirement health and other welfare benefits meets the definition of a liability, and it is sufficiently measurable, reliable, and relevant to financial statement users to warrant accrual accounting. The Board concluded that a measure of the obligation and accrual of the cost based on estimates is superior to implying, by a failure to accrue, that no obligation or cost exists prior to the payment of benefits. Further, the Board concluded that failure to recognize the existence of the obligation or cost impairs the usefulness and integrity of employers' financial statements.

A single method will be prescribed for measuring and recognizing an employer's obligation and the related net periodic cost. That method attributes benefits to the related service periods, drawing on the notions underlying accounting for other forms of deferred compensation earned by employees, such as pensions, that are also generally paid during retirement.

The use of assumptions that represent an employer's best estimate solely with respect to that individual assumption, and attribution of the expected retiree welfare benefits to employee service periods, are fundamental to measuring the accumulated benefit obligation and related cost for a period. Determination of the accumulated benefit obligation and cost consider actuarial assumptions such as the time value of money; the timing and amount of future benefits; and the probability of payment, considering factors such as turnover, retirement age, dependency status, mortality and so forth.

Most retiree health care plans do not promise a specified dollar benefit at retirement; rather, they promise reimbursement of incurred medical expenses. Accordingly, the foundation for estimating the timing and amount of future health care benefits is the estimated per capita future claims cost by age. Expectations of future retiree health care claims costs include consideration of past and present claim status, health care cost trend rates, and medical coverage provided by Medicare and other providers of health care benefits.

The Board believes that the resulting measurement and recognition of the employer's obligation and cost should provide a more meaningful and credible representation of an employer's financial condition that will be more useful to management, investors, creditors, and others who use the financial statements in their decision-making process.

The issue of how and when to begin recognizing the existing obligation for future postretirement benefits arising from employee services already rendered is a sensitive one. Employers face, for the first time, the prospect of accruing the cost of retiree health and other welfare benefits exchanged for current service, as well as accounting for the cost of those future benefits already exchanged for prior service.

The Board concluded that recognition of that transition obligation should be considered a practical matter, and that a major objective of transition is to minimize the cost of change and to mitigate the disruption involved, to the extent that is possible without unduly compromising the objective of enhancing the ability of financial statements to provide useful information. That led the board to conclude that the initial emphasis of the proposed standard should be on disclosure and current cost, phasing in balance sheet recognition and prior service costs over the average remaining service periods of the employees who are expected to receive the benefits; 15 years may be used if that is greater. Commencing in 1994, however, employers will be required to recognize a minimum liability on their balance sheet that is measured as the unfunded benefit obligation for retirees.

Jim Leisenring will now conclude our remarks to the subcommittee.

Mr. LEISENRING. As you have noted in recent speeches, Mr. Chairman, the proposed accounting does not change the nature and extent of the postretirement benefit promise at all. The cost of business is the same before and after this promise is recognized in the employer's financial statements. The proposed standard will require businesses to publicly acknowledge their existing commitments. Investors can then evaluate the wisdom of those promises.

The issuance of the exposure draft of the FASB's proposed accounting for employers' obligations to provide postretirement benefits other than pensions is a very significant step in the Board's decisionmaking process, but it is not the culmination of that process. We will continue to consult with our task force members and others on the proposed accounting and implementation of the proposed standard. The Financial Executives Institute is sponsoring a field test of the proposed accounting that will also provide us with useful information on implementation of the proposed standard. In addition, the Board considers very carefully the views of respondents to the exposure draft and commentators at our public hearings. The FASB will fully consider those comments, and will inevitably be persuaded to reconsider its position on many issues before issuing the final accounting standard on employers' accounting for postretirement benefits other than pensions.

Mr. Chairman, that concludes our prepared comments. We will be pleased to answer questions of the subcommittee. Thank you.

Chairman PICKLE. Thank you, Mr. Leisenring, and Ms. Scott for your statement.

Now, Mr. Leisenring, in your statement you have just made, page five, you said that the Board resumed its consideration of the postretirement benefits, and you say that "In the next few months, the board expects to issue for comment an exposure draft."

It was my general feeling, based on comments and publication, and in verbal conversation, that you were going to issue this exposure draft next month.

Is that correct or not correct?

Mr. LEISENRING. It may be correct, but I equivocated a little bit in my statement. We publish, quarterly, a technical plan, Mr. Chairman, and we announce what quarter we will issue something, and our timetables are known to slip just a little bit and——

Chairman PICKLE. Well, what has caused your delay?

Mr. LEISENRING. Internal debate is one.

Chairman PICKLE. I think the Congress and the business community, and the working community have been waiting for your recommendation.

Now, what has caused the delay in issuing what you think should be the accounting principles?

Mr. LEISENRING. What has caused the delay is the complexity of the issue and the internal debate among the Board members in reaching conclusions that a majority of the Board will support.

I do not think that delay will go beyond the end of October, and probably will not, in any way, change the effective date of when the standard would have to be complied with.

Chairman PICKLE. Well, Mr. Leisenring, I have been reading a lot of different publications, and most of the national magazines, and on September the 12th of this year, the Business Week publication published an article alleging that corporations, through the Business Roundtable, are putting pressure on the FASB, and the Securities and Exchange Commission to blunt their report, and to delay it.

Are you aware of any pressure on the FASB?

Mr. LEISENRING. Mr. Chairman, the FASB is an instrument of change in a world that sometimes resists that. I do not think that the types of pressure that we have received recently are abnormal for our environment. We have had pressures on us in different directions for 15 years, and I think it is a bit of an overstatement in that article to imply that the pressure should stop.

Chairman PICKLE. You say it is an overstatement, but you indicate you do have pressure but you do not think it is abnormal?

Mr. LEISENRING. That is correct, sir.

Chairman PICKLE. Well, now, I am going to take the committee's time and read something which was handed to me this morning.

This is a statement that was in the editorial column of the Business Week of September the 19th.

Now this is the week following the first article and the heading on it says, "FASB Shines A Light Into A Can Of Worms." And this is what it said. It will take me 2 or 3 minutes. I am going to ask the extra time of the committee.

It is notoriously risky to be the bearer of bad news. The messenger is often deeply resented. That is the fix the Financial Accounting Standards Board finds itself in. It is drafting rules to force businesses to report the cost of disastrously inflated promises they have made to their retirees for health insurance.

Some estimates put the price tag as high as $1 trillion and predict a fourfold increase in the the expenses that companies are now booking. But the U.S. industry cannot point a finger at anyone but itself for the problem, certainly not at FASB—it is just shining a little light into this can of worms.

FASB has a thankless and futile task. Although it has issued almost 100 accounting rules since it was started in 1973, corporate accountants continue to find ways to whisk important numbers off the balance sheet faster than FASB can drag them back on.

And when FASB tackles another problem with a ruling, corporate managers often complain that it makes more work for the bean counters, while investors and lenders fret that the newly ordered disclosures do not go far enough.

And one more statement.

In addressing the way retirees' health costs are booked, FASB has correctly put its finger on an issue that is going to rile not just CEOs but unions, retiree groups, and politicians.

Nevertheless, it ought to be free to do its job, to make rules based on public debate rather than arm-twisting by such powerful groups as the Business Roundtable. Don't bash the messenger because the news is bad. The job is tough enough already.

Now that is a statement that the editorial board of Business Week has just made. Would you make a comment on that.

Mr. LEISENRING. Well, there is some truth to the fact that people enjoy, at times, shooting the messengers, but I think it overstates a couple of points, or at least mischaracterizes the business view.

I do not believe we are criticized for addressing this issue. At least I do not believe we have been criticized by many for that, and the debate will be, which is naturally so, over what our conclusion is.

There are very complex accounting issues here that Diana alluded to in her testimony such as how to measure the obligation and the timing of that measurement I think that our process is such that we almost elicit the type of debate they are afraid will unduly pressure us, but we do, as I indicated, solicit those comments to try and understand a variety of views.

The implication of the article is that the business community does not share our interest in credible financial reporting, and I think that is erroneous. I think the business community, issuers, and auditors, also have not only an obligation but they are acutely aware of their obligation to promote credible financial reporting.

So while I appreciate the comments, I think, again, it is a bit of an overstatement.

Chairman PICKLE. How long have you at FASB been considering issuing this exposure draft? How long have you had this under study?

Mr. LEISENRING. Really actively, other postretirement benefits, not just the general area of retirement benefits for which pensions occupied the bulk of our time, only since the beginning of 1984.

Chairman PICKLE. Now that is almost 4 years of consideration.

Well, let me make the observation, that nobody likes to get bad news, least of all Congressmen and CEOs.

Therefore, based on what we have seen or heard so far, my guess is that the FASB is going to make a lot of people unhappy once you release your report. At least that is the general portent of it.

Now I, as one member of this committee, the chairman of the committee, will ask that you, FASB, stick by your guns and issue your report as quickly as you can, and that you base it on sound accounting principles.

I ask that you not be persuaded by either pressure from the Hill or from the unions, or from the corporations.

We are awaiting your report. The Congress has a right to receive it. You were created by business to try to maintain sound accounting principles. That is what we are asking that you do now.

So I am going to ask that you stay by your guns and give us your report, and that you base it on sound accounting principles, and I hope that you do not make any undue delays.

Get it to us so the American people and the Congress can go to work on it.

Now, one last question. The GAO testified that the value of these retiree health care plans now, at least, would be, based on their estimate, at least $402 billion.

Does that figure sound reasonable to you? Do you question it? Do you think it might be more or less, or is that a fairly accurate estimate as best you could tell?

Mr. LEISENRING. Mr. Chairman, I do not think that the FASB has the knowledge base to either question it, but also, equally, do not have the ability to endorse it.

Individual companies' liabilities are so dependent on their particular fact circumstances, and any aggregation of that is dependent on the accuracy of individual company recordkeeping. The one thing that we have learned in this study, from our staff, is that the lack of records and the ability to make some of the measurements that we are calling for is a very serious problem.

That is one of the reasons why we are going to delay the effective date for having to comply with our standard—to allow companies the time to develop the data to be able to realistically do——

Chairman PICKLE. Well, now, Mr. Leisenring, you——

Mr. LEISENRING. So I do not know whether the number is appropriate.

Chairman PICKLE. It seems to me, now, from my own observation, that you are equivocating with this approach.

I would not expect you, FASB, to know exactly from a dollar standpoint what is the figure. But I would expect you to say to me, when a company makes a promise for a retiree health plan, that is a promise and that is a liability. Is that true?

Mr. LEISENRING. That is what the document will assert. Yes, sir. That is our conclusion.

Chairman PICKLE. All right. Now if that is your conclusion, you arrive at it based on a lot of figures you must get from companies across the land. You just did not reach up in the air and pull that out from cloud 9.

Mr. LEISENRING. You did not ask me, though, whether it was a liability. You asked me, rather, on a national basis, how much it was. Those are distinctly different questions.

Chairman PICKLE. Yes. But you would have some general feeling, whether this is so or not. It is a big issue, it is a very serious problem, and you have some idea of whether the liability is that much. If you did not, it may not be of great interest to you.

So I am just saying you ought to have some kind of a feel, whether you think that figure is about accurate.

If you disagree with it, I want you to submit to this committee some information to show why you think it is not that much. But no matter. The important thing is: when are you going to issue this report, when can we have it so we can go to work?

We are ready to look at this thing. We are awaiting your response.

Mr. LEISENRING. You will have it this year, I assure you.

Chairman PICKLE. We will be awaiting its release.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. Chairman, you said that this has to be bad news. I do not know whether it necessarily is bad news.

What it is is probably a little dose of realism. The bad news might be how we react to it, if we overreact. It seems to me that Ms. Scott put her finger on it when she discussed the transition rules and how they will be handled.

I believe everybody realizes that this obligation is out there and it is a matter of how it is handled from an accounting standpoint. So I do not know whether it is necessarily bad news for American business. It just depends upon how it will be handled.

I can understand the pressures that you might be under, depending upon the company, the liabilities, the size of their liability, and even the type of future they see.

I am sure you will be subjected to many pressures, and out of those myriad of pressures hopefully will come some kind of sensible plans.

Ms. Scott, you did discuss transition rules. Do you have any thoughts on the direction that that will go or will there be a wide variety of transition rules or could that be narrowly defined?

Ms. SCOTT. The document proposes one rule for transition that would require an employer to recognize the unfunded obligation that exists at the date the standard is initially applied.

It would attribute that to the average remaining service lives of the employees who are expected to receive the benefits.

Now if that period of time happens to be less than 15 years, as a practical matter, and because this is a difficult issue, you can use 15 years.

However, we do have one constraint, and that constraint is that the amount of the transition obligation that is recognized cannot be less than the cost that would have been recognized for retirees at the date of transition, had the employer continued to account for the obligation on a pay-as-you-go basis.

So it will not give a break by delaying the recognition of those costs. It would say it can be no less rapid than recognition would have been on a pay-as-you-go basis.

Mr. SCHULZE. But it certainly would have to be done on an individual company by company basis. It cannot be done on a broad base, and that is why it is difficult for us to get figures because there are such varieties.

And not only that. But I would presume this will trigger a fair number of changes in plans, depending on what your recommendations are, and what our reaction to this whole thing is.

Mr. LEISENRING. I do not think there is any doubt about that, and the chairman thought I was equivocating on the liability. I was not equivocating, just denying knowledge as to the size of it on a macro basis. I am not equipped to answer that question.

But I absolutely know that on an individual company basis, which is after all the concern of financial statements, and the

FASB's jurisdiction, on an individual basis, the numbers for many companies are very, very large, and the size of that number, as well as the difficulty in the estimation process to measurement, as Diana suggested, has caused us to take a rather pragmatic view as to transition, and hope that we can get better at this over the next 10 or 12 or 15 years.

Mr. SCHULZE. Just as they are large for industry, the tax ramifications would also be large for the Federal Government.

I hope as you look at transition rules you will think of this as a two-edged sword. It will work both ways. Perhaps you may also look at the types of industries, as I discussed earlier. If we are putting a greater impact on some of our aging or mature industries, perhaps we should take that into account.

Are there either accounting methods or methods through the Tax Code, that help the transition period, or relieve some of that immediate pressure which it might create?

I thank you for your testimony, and yield back the balance of my time.

Mr. ANTHONY [presiding]. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Leisenring and Ms. Scott, I want to thank you for your very excellent testimony, and your willingness to deal with this subject.

I would just observe that there has been a good deal of criticism by the users of financial statements, that the users have not been furnished adequate information, and I think it is true that probably the fastest growing sections of most of our accounting firms today is probably the legal department.

And I know many committees of Congress have held hearings about this area, and have encouraged the accounting profession and FASB, and others, to take action to address some of those concerns.

Your mission, should you decide to accept it, and apparently you have, is to try to bring about those changes that add a good deal more relevance, and I think it is a very important mission.

The goals that you are measuring this by I believe still involve placing on the financial statements those things that are definite, that are objective, and that are measurable.

It seems to still be the standards that you use, and I think they are very important ones. I am wondering if most of the analysts—you mentioned the role that financial statements play in the allocation of capital.

Do you think most of those analysts of financial statements are already aware of these liabilities that are not on the statements, and, in your opinion, have they already discounted the values of the stock to account for that in many instances?

Mr. LEISENRING. This will sound like I am equivocating as well. You have people, testifying later that are better equipped to answer the question than I, but I would answer it, I believe, yes.

I suspect they do not know exactly what the liability is for given companies because many of the companies do not know that.

But surely, they notionally have considered that there are certain segments of industry with a larger obligation, or at least potentially a much larger obligation than others, and it would be naive to assume that there has not been some recognition of that,

particularly since our document on disclosure of health care costs for retirees was issued in 1984.

Mr. FLIPPO. And certainly you are aware, I am sure, that our current tax code does not use the same timing measurements as you are recommending in defining income for income tax purposes, or to define when to recognize some expense or liability associated with it.

As a matter of fact, this great difference between the FASB and the IRS in fact means that previous financial reports have in fact overstated income by understating the expense associated with these retirement operations.

And therefore you could argue that greater—if those things were reconciled, that they paid greater taxes than they would have otherwise been required to.

Mr. LEISENRING. With respect to this issue, the tax law and the financial accounting has not been dissimilar.

Most companies have been on a cash basis and the tax law allows that same cash basis.

Mr. FLIPPO. Yes.

Mr. LEISENRING. Our proposal will create the very——

Mr. FLIPPO. Right. And that is the point I was trying to make in a takeoff on Mr. Schulze.

Have you made any analysis, that you could share with us, as to the tax consequences of your recommendations under current law, and what current laws—perhaps you could share with us what current law changes would enhance this transition, or make it easier to, or reduce the opposition to adopting the recommendations of FASB.

Mr. LEISENRING. Well, for the record, we do not take positions on tax policy or public policy. That is your area, not ours, but in the spirit that you asked the question, surely existing policies are an impediment to wanting to accrue the benefit.

We are going to require that accrual. The inability to deduct it is obviously a disincentive to the accrual. So to that extent the current tax policy will add to the negative reception that our proposal will receive.

At the same time, make sure you understand that we distinguish, in the pension area as well as here, between funding and accrual, and we are not talking about funding.

Mr. FLIPPO. Yes.

Mr. LEISENRING. That is yet a different public policy issue as to whether funding should be encouraged or discouraged. We are not taking a position, really, on that at all, in our document, other than to say they are distinct, and we are looking at the expense and liability recognition.

Mr. FLIPPO. Well, while this committee is charged with the responsibility for raising revenue, we are also very concerned, and share your concerns about the proper allocation of capital in this country, and we want to make sure that the Tax Code comports with that objective.

So thank you very much for your testimony, and I do not envy you in carrying it out.

Mr. LEISENRING. Thank you.

Mr. ANTHONY. Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman.

I believe I know that you are being pressed by the chairman for a date of your report. I know how you feel. My campaign committee wants to know when Congress will adjourn, and I will be home to campaign.

My guess is probably about as good as yours. This year.

Your statement, Ms. Scott, that the board concluded that an employer's obligation to provide postretirement health and other welfare benefits meets the definition of a liability and is sufficiently measurable, reliable, and relevant to financial statement users to warrant accrual accounting, is really the foundation of this whole process that we are talking about.

The thing that makes me curious though is, at the bottom of that page, your suggestion that a single method will be prescribed for measuring and recognizing an employer's obligation and the related net periodic cost.

Is that what is giving you the trouble, determining the method for determining what the liability is?

Ms. SCOTT. Actually, no, it is not. The board has looked at several different methods and several months ago concluded on a method that is similar to the methodology used in accounting for pensions because of the similarities between the two forms of deferred compensation.

There really is only one issue that is unresolved, and that issue focuses on when the benefits should be fully accrued—at the end of a person's service period, or at the date that the person is entitled to leave and take the benefit with them—what we call the date of first eligibility for the benefit. That is the only unresolved issue.

Mr. CHANDLER. You went on to say in your testimony, that most of these retiree health care plans promise a benefit. They promise reimbursement of incurred medical expenses rather than a specific dollar amount.

Does this make it a volatile one in estimating what that benefit will be, given the rapid inflation of health care costs, and uncertainties of what the Government will do in terms of medical care programs for seniors, and so forth?

Ms. SCOTT. It undoubtedly is more volatile. It has all of the assumptions you would have for pensions, plus consideration of health care cost trend rates.

Mr. LEISENRING. Volatile is probably the result but it is also, I think, first and foremost, just more difficult. The estimation techniques are much more refined, and we are experienced in pensions, and if someone guarantees a benefit of x number of dollars a year, y years hence, we are much better equipped, historically, to deal with that than we are the uncertainty, as you point out, of the health care cost trend rate. There are some other assumptions as well about health care that are just more difficult, and we have had less experience estimating them, which has made the project more difficult from our standpoint.

Mr. CHANDLER. You heard, didn't you, the testimony of Mr. Thompson from GAO?

Mr. LEISENRING. Yes.

Mr. CHANDLER. From what you heard, did that seem to be a reasonable estimate, reasonably reliable, based on the methodology that they used?

Is that something this committee can hang its hat on?

Mr. LEISENRING. I think that what the committee has to hang its hat on is that the number is very large. I do not know whether it is $400 billion or $450 billion and I do not know what margin of error would be tolerable, if I were to make a projection. As I told the Chairman, I do not have a basis for any projection on a macro or nationwide basis.

But it is very, very significant, and it is very significant for individual companies as well.

I do not think that anyone knows the exact dollar amount—I do not think we have the basis to determine that yet. Certainly the FASB does not, and we do not have the resources of a GAO to attempt to estimate it. I have no reason to doubt their skill, they are a very competent organization, but I also do not have a basis for agreeing with it.

In part, we are reluctant to say what we think is probably an appropriate estimate, because we know, on an individual company basis, how uncertain they are about the amount of obligation.

It intuitively strikes me, that if individual companies do not know, it is very difficult to have aggregated all of those individual companies and have a number that is very precise.

Mr. CHANDLER. But what you heard did not strike you as irresponsible?

Mr. LEISENRING. No, absolutely not at all.

Mr. CHANDLER. Or outlandish or anything of the kind?

Mr. LEISENRING. Certainly not at all. No, sir.

Mr. CHANDLER. It is possible, then, it could have even been understated?

Mr. LEISENRING. Certainly, and I think they acknowledge that. They made their best effort, but I know it was a difficult effort because of the quality of the data they must have had to work with.

Mr. CHANDLER. Will part of your report include an estimate of total liability?

Mr. LEISENRING. No, sir.

Mr. CHANDLER. That is not to be expected. Thank you, Mr. Chairman.

Mr. ANTHONY. Thank you, Mr. Chandler. The committee thanks you for your testimony, and the chairman's strong admonition to encourage you to resist the temptations of pressure, and to bring your report out speedily so we can take a look at it, and I guess I share Mr. Flippo's viewpoint.

You have undertaken a tough assignment, but it is an important assignment, and we wish you the best of luck.

Thank you for your contribution to the hearing.

Our next witnesses will be a panel consisting of a representative from the Employee Benefit Research Institute, Deborah Chollet, senior researcher; Mercer Meidinger Hansen, Inc., represented by Jonathan C. Dopkeen, Ph.D.; Morgan Stanley & Co., Inc., represented by Jeremy Gold, principal; Coopers & Lybrand represented by Harold Dankner, senior partner.

We would take the testimony from Ms. Chollet first, and then Dopkeen, Gold and Dankner, and if you would, we will withhold our questions until after you have had an opportunity to make your presentation.

We would take your entire statement for the entire record, and you may be permitted to read it, summarize it, or present it as you deem best.

You are now recognized, Ms. Chollet.

STATEMENT OF DEBORAH J. CHOLLET, PH.D., SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Ms. CHOLLET. Thank you. Good morning.

I'm Deborah Chollet. I am senior research associate at the Employee Benefit Research Institute. As I believe many of you know, EBRI is a private, nonprofit, nonpartisan public policy research institute, and we do not take positions on public policy issues.

I am pleased to appear before you today to present some of the results of our research on retiree health insurance benefits and financing.

My written statement includes a number of tables with data describing the retiree health insurance benefits anticipated by today's workers and the prevalence of retiree health benefits among current retirees.

I would refer you to those tables for a fuller description of some of the summary points I will be making this morning.

Continuation of health insurance benefits is a common feature of both private and public employee plans. In 1986, 75 percent of full-time permanent workers in medium-size and large establishments in the United States had plans that would continue benefits after early retirement; 68 percent had plans that would continue benefits after retirement at age 65. For most of these workers, all but 11 percent, the employer will pay all or part of the cost of the plan.

Although public employees, Federal, State, and local government workers are less likely than large firm private workers to have retiree coverage, retiree health insurance is also a common feature of public employee plans.

Data from the Bureau of Labor statistics indicate that retiree health insurance has become more common as a private sector employee benefit during the 1980's, especially in very large establishments—those employing 2,500 workers or more—and in manufacturing establishments.

Between 1981 and 1985, the number of workers in large manufacturing establishments with health insurance that would continue benefits after retirement at age 65 increased nearly 20 percent. The number of workers in very large establishments with these benefits apparently increased as much as 50 percent.

Among retirees, employer-sponsored health plans are an important and apparently growing source of private insurance coverage. In 1984, the most recent year for which data are available, more than 11 million retirees, age 55 or older, reported coverage from a retiree health insurance plan. Nearly 8 million of these retirees were aged 65 or older.

These data suggest that approximately one-half of today's elderly with private insurance to supplement Medicare obtain all or part of their coverage from a retiree health insurance plan.

Most retirees who receive health insurance from a past employer have low or moderate income. These are not high income retirees. In 1985, 56 percent of retirees over age 65 reporting retiree health insurance coverage had family income of less than $20,000. Seventy percent reported family income of less than $25,000. Retiree health insurance benefits for these workers represent an important and growing source of real income.

At least half of all retirees with health insurance benefits from a past employer, and as many as 70 percent, obtain their benefit from a private corporate sponsored retiree health insurance plan. For most of these retirees, about 85 percent, the plan sponsor pays all or part of the cost of the coverage. However, an important minority, about 15 percent of retirees, with private retiree health plan coverage, pay the full cost of the plan themselves.

Corporate liabilities for retirees for whom they contribute are substantial. To date, virtually all of this liability represents an unfunded obligation to pay benefits over the lifetimes of retirees and their surviving spouses.

Our current estimate of the corporate liability associated with the retiree health insurance benefits for retirees and workers is $169 billion, $68 billion for retirees now receiving benefits, and $101 billion for workers not yet retired. This estimate is different from the $221 billion estimate of accrued liability that GAO reported to you earlier this morning, principally because we have adjusted them for the anticipated value of the new Medicare benefits enacted earlier this year. These benefits phased in over a 5-year period are likely to greatly reduce employer liability for the benefits provided to retirees over age 65. Obviously they affect none of the benefits for retirees under age 65.

Most of the saving is likely to occur as a consequence of Medicare's coverage of prescription drugs. Excluding any adjustment for expanded Medicare benefits, our estimate of unfunded liability is $247 billion for both current retirees and workers not yet retired. This estimate is very comparable to that produced by the GAO.

The average cost to employers of amortizing unfunded liabilities of even $68 billion, the liability associated with current retirees, over, say, a 15-year period, would be substantial. Aggregate annual costs to private employers could exceed $7 billion, representing at least, very conservatively, a 10- to 15-percent increase in spending for health insurance benefits among corporations and sponsor retiree health benefits. That is an increase in the total amount that employers now pay for benefits provided to current workers as well as retirees.

If employers were to amortize the full cost of retiree health liabilities for both retirees and current workers, the annual cost could exceed $18 billion, raising annual spending for health insurance benefits by 25 to 30 percent or more for corporations that sponsor these plans.

The cost on financing issues confronting employers that sponsor retiree health insurance benefits are difficult. The public policy issues that emerge are basic. They include the economic security of

a large number of older Americans, many of whom rely on these benefits as an important source of real income or as their only access to health insurance coverage. They also include the wide range of public sector concerns associated with corporate financial stability.

Finally, and perhaps ultimately most important, they include the challenge to develop a workable system of retirement financing for baby-boom workers, a generation that threatens to overwhelm public systems of health care financing as they move into retirement.

I thank you for the opportunity to appear before you today, and I would be pleased to assist the committee in any way possible as you consider these issues.

[The statement of Ms. Chollet follows:]

STATEMENT OF DEBORAH J. CHOLLET, PH.D., SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Retiree health insurance--its cost, funding and future--has become the basis of major concern and controversy among employers and public policy makers. Data on the prevalence or distribution of these benefits have been scarce. Nevertheless, employers with retiree health plans have claimed that funding these benefits during active workers' careers (similar to the way that pensions are funded under current law) would represent an enormous current expense. While the Congress has been concerned that retirees who expect these benefits may have no real claim to benefits in the event a plan termination or sponsor bankruptcy, the prospect of tax revenue losses may impede legislation allowing tax preferences to encourage employer funding.

This testimony examines the prevalence of retiree health insurance as an employee benefit, and the prevalence and distribution of retiree health insurance benefits among both early retirees (age 55 to 64) and retirees age 65 or older. The data presented include (and distinguish between) retirees who receive private-plan benefits and those who receive benefits from a public employer plan--federal, state or local governments. Revised estimates of the present value of employer liability are presented, differentiating between the liability of private and public employers and between liability for benefits being provided for current retirees versus future benefits for workers not yet retired. Finally, estimates of the annual cost to employers of amortizing unfunded liability for current retirees and workers are presented.

Retiree Health Insurance as an Employee Benefit

Continuation of health insurance benefits after retirement is a common feature of both private and public employer plans. In 1986, three-quarters (75.2 percent) of full-time workers in medium or large private-sector establishments participated in health insurance plans that continued coverage after early retirement (before age 65); more than two-thirds (68.4 percent) participated in plans that continued coverage after retirement at age 65 (U.S. Department of Labor, 1987).

Most plans that continue coverage after retirement also provide for an employer (or sponsor) contribution to the cost of coverage (see Table 1). In 1986, 64 percent of full-time workers in medium or large private-sector establishments had plans that continued coverage after early retirement with the plan sponsor paying all or part of the plan cost; 58 percent had plans with fully or partly sponsor-financed coverage after retirement at age 65. Approximately 39 percent of workers in larger private-sector establishments had health insurance plans for which the plan sponsor paid the full cost of coverage after either early or normal retirement.

Fully or partly sponsor-paid retiree coverage is less common among public-sector workers (state and local government employees) than among private-sector workers in larger establishments. In 1987, nearly half (47 percent) of full-time state or local government workers with employer-based health insurance had plans that would continue with a sponsor contribution after early retirement; 44 percent had coverage that would continue with a sponsor contribution after retirement at age 65. About one-half of state and local employees that participate in plans where the employer contributes have the full cost of coverage after retirement paid by the plan sponsor.

Employer plans that continue coverage typically continue benefits at the same level as that provided to workers before retirement; that is, the scope of services covered and retirees' cost-sharing under the plan are maintained at preretirement levels. However, presumably all plans integrate Medicare coverage into plan benefits. That is, Medicare is "first-payor" for services covered by both Medicare and the retiree plan.[1] Because Medicare integration substantially reduces plan costs, it has probably encouraged the growth of health insurance as a retiree benefit.

Since 1981 (the first year for which data are available), the number of workers with health insurance plans that continue coverage after retirement has grown substantially. Between 1981 and 1985, the number of private-sector workers with plans that provide benefits after early retirement grew by more

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[1]Alternative methods of Medicare integration are described in: D.J. Chollet and R.B. Friedland, 1987.

than 14 percent (see Table 2); the number of private-sector workers with plans that continue coverage after age 65 grew 18 percent. The most rapid growth of retiree benefits occurred among workers in manufacturing establishments and workers in very large establishments (establishments with 2500 workers or more). The number of workers in medium-size and large manufacturing establishments with plans that continue benefits after retirement at age 65 grew nearly 20 percent between 1981 and 1985. The number of workers in very large establishments with this benefit grew 50 percent.

Retirees with employer-sponsored coverage

Employer-sponsored plans are an important source of health insurance among retirees. In 1984 (the most recent year for which data are available), at least 11.3 million retirees age 55 or older had health insurance from an employer-sponsored plan (see Table 3). Of these, 7.6 million were age 65 or older. Among all elderly in 1984, at least 29 percent reported having health insurance coverage from a past employer.

The evolution of retiree coverage as a feature of employer health plans is reflected in higher rates of retiree coverage among recent retirees. In 1984, nearly one-third of the elderly age 65-69 (33 percent) reported health insurance coverage from a past employer, compared to just over one-quarter (26 percent) of elderly age 75 or older.

Employer-sponsored retiree health insurance plans represent a substantial share of the elderly's Medigap insurance (see Table 4). Among all people age 65 or older with private insurance to supplement Medicare (62 percent of the elderly in 1984), about one-half--47 percent--had all or part of that coverage provided by an employer-sponsored retiree health insurance plan. Including employer coverage presumed to be received as a current worker benefit, but possibly received as a retiree, nearly 60 percent of the elderly with private coverage to supplement Medicare derived all or part of that coverage from an employer plan.

Most retirees who report health insurance from a past employer live in low- and middle-income families. Consequently, health insurance benefits represent an important real income supplement for most of the retirees that have them. In 1984, more than one-half of the elderly with retiree health insurance (56 percent) had family income of less than $20,000; 79 percent had family income of less than $30,000 (see Table 5). Retirees under age 65 with health insurance from a past employer report slightly higher, but generally comparable levels of family income. In 1984, 47 percent of early retirees with employer-sponsored health insurance reported family income of less than $20,000; 76 percent reported family income of less than $30,000.

Available data do directly not indicate whether the health insurance benefits that retirees are now receiving are sponsored by a private or public employer. Nevertheless, most retirees' health plan sponsors can be inferred from available data about their pension plan sponsors. From those data, we estimate that at least half of all retirees with health insurance from a past employer receive coverage from a private employer plan; that is, the retiree also receives income from a private pension plan (see Table 6). While 20 percent of retirees with health insurance from a past employer report no current pension income, most of these individuals probably receive their health insurance benefits also from a private plan sponsor. At least 30 percent of retirees now receiving health insurance from a past employer have coverage as a retiree from public employment-- federal, state or local government.

Evidence that private employer plans have been providing retiree benefits with increasing frequency, and that retiree coverage as a public plan benefit matured relatively early, is again apparent in the relatively high rate of private employer-sponsored coverage reported among recent retirees (and, conversely, their relatively low rate of public-plan coverage). Among covered retirees age 75 or older, 44 percent had coverage sponsored by a private employer, and 31 percent had coverage from a public employer plan. By comparison, among younger retirees (age 65-69), at least 55 percent of all retirees with coverage from a past employer apparently had their coverage from a private employer plan; 28 percent had public-employer sponsored coverage.

While most retirees receive some contribution to the cost of their plan (a characteristic of private and public plans that is clear from the BLS data on active workers' plans described earlier), an important minority report that they pay the full cost of coverage themselves, with no sponsor contribution. In 1984, nearly 22 percent of all retirees paid the full cost of coverage without a sponsor contribution; among retirees age 65 or older, 23 percent paid the full cost of coverage (see Table 7). Conversely, for nearly 39 percent of retirees with health insurance from a past employer, the plan sponsor paid the full cost of coverage.

The likelihood that the plan sponsor contributes all or part of the cost of coverage is substantially higher among retirees with coverage from a private plan compared to those with public-plan coverage, an observation also consistent with the reported features of active worker plans. Among both early retirees (age 55 to 64) and retirees age 65 or older with private-plan coverage, approximately one-half (49 percent and 51 percent, respectively) had their coverage fully paid by the plan sponsor.[2] By comparison, about one-quarter of retirees with coverage from a public employer (23 percent) had the full cost of coverage paid by the plan sponsor.

Employer Liability for Retiree Benefits

Revised estimates of private and public employer liability for retiree health insurance benefits are reported in Table 8. Although these estimates are reported together, they are of public policy interest for very different reasons. In particular, private employers are confronting the prospect of new accounting rules that would require them to recognize on their balance liability for benefit obligations to retirees and, potentially, benefit promises made to current workers. Virtually all of this liability is, at present, unfunded. Amortized and reported over some allowable period, this liability would offset corporation income and, consequently, reduce reported profit. Because these liabilities are unevenly distributed, even among employers with retiree health plans, a reallignment of relative corporate profits will probably ensue. If, as seems likely, equity markets have not fully anticipated the retiree health benefit liability of individual corporations, the reallignment of corporate profitability would produce an adjustment in the relative value of corporate stocks.

The issues associated with public employer liability for retiree health insurance are somewhat different. Public-employer liabilities represent a claim against future tax dollars. The current cost of state and local government obligations for retiree health benefits directly affects their their operating budgets and poses an increasing strain on fiscal management. Most states and municipalities are required to balance their budgets annually.

We estimate that the present value of private employers' liability for retiree health insurance obligations is approximately $169 billion. Most of this liability, nearly $101 billion, is associated with current workers. The present value of corporate liability for current retirees is slightly more than $68 billion.

These estimates are low relative to those that have been presented by other researchers, and substantially lower than the trillion-dollar estimates that have been been reported by the press. The single major reason that these estimates appear relatively low is that they include a downward adjustment for recent legislation expanding Medicare benefits.

The value of the new Medicare benefits to plan sponsors can vary radically from plan to plan, depending on the plan provisions, the Medicare assignment rate among physicians in the areas where retirees live, and a host of other factors. Our estimates assume that the new Medicare coverage reduces employer plan costs by 10 percent in 1990, 40 percent in 1991, 45 percent in 1992, and 50 percent in subsequent years. This assumption, applied to both private and public plans, reduces estimated liability by approximately 30 percent. Without this adjustment, we estimate that the present value of private, corporate liability for retiree health benefits would be $247

[2]Because retirees in plans for whom the plan sponsor was indeterminable are excluded, the percent of retirees in private plans with coverage that is fully paid by the plan sponsor may be biased upward slightly.

billion: $98 for current retirees, and $149 billion for current workers.[4]

A second major assumption implicit in our estimates is the projected rate of inflation in health care services. The estimates reported here assume that health care cost inflation continues to exceed general inflation, but that the difference between the rates declines incrementally over the next 25 years. The rates of inflation are assumed to converge (at 5 percent per year) when aggregate spending for health care services reaches 22 percent of GNP.

Calculating the annual cost to amortize employer obligations over some hypothetical period is fairly simple, and produces some idea of the current cost that funding retiree health benefit liabilities may pose for corporations aggregately. Assuming that employers are able to amortize unfunded liabilities for current retirees over fifteen years, aggregate annual cost would be approximately $7.4 billion. This cost alone could represent a substantial increase in annual corporate spending for health insurance benefits -- 10 percent or more for corporations that sponsor these plans. If employers were to amortize the full cost of retiree health liabilities for both retirees and current workers, the annual cost could exceed $18 billion. This annual cost could raise annual spending for health insurance benefits by more than 25 percent for corporations that sponsor retiree health benefits.

Concluding remarks

The issues surrounding the retiree health insurance benefits provided by private corporations and public employers are difficult and complex. They fundamentally include retirees' economic well-being and, respectively, corporate financial stability and public-sector budgeting. New accounting rules are likely to make urgent the consideration of tax relief to facilitate funding of corporate liabilities. We congratulate the Committee for focusing on these issues early, and stand ready to assist the Congress by providing data and analysis to inform their debate.

References

Chollet, Deborah J. and Robert B. Friedland, "Employer-Paid Retiree Health Insurance: History and Prospects for Growth," in F.B. McArdle, ed., The Changing Health Care Market (Washington, D.C.: Employee Benefit Research Institute, 1987).

U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms, 1986, Bulletin 2281 (Washington, D.C.: U.S. Government Printing Office, June 1987), Tables 29 and 30.

Table 1
Percent of Private- and Public-Employer Health Insurance Plan Participants with an Employer Contribution to Coverage After Retirement, by Selected Benefit Provisions and Age of Retiree, 1986-1987

Benefit Provision	Medium-Size and Large Private Employer Plans[a]		State and Local Public Plans[b]	
	Retirees Under 65	Retirees 65 or Older	Retirees Under 65	Retirees 65 or Older
With retiree coverage	64%	58%	47%	44%
Effect of retirement on benefit level:				
No change	50	46	45	41
Reduced coverage	12	10	3	3
Increased coverage	1	1	c	c
Retiree share of cost:				
Partial cost	19	14	24	23
No cost	33	34	24	24
No retiree coverage	22	29	48	52
Provision not determinable	2	2	2	2
Retiree policy not established	1	1	d	d
Other[e]	1	1	d	d

Source: Estimated from: U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms, 1986, Bulletin 2281 (Washington, D.C.: U.S. Government Printing Office, June 1987), Tables 29 and 30; and U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in State and Local Governments, 1987, Bulletin 2309 (Washington, D.C.: U.S. Government Printing Office, May 1988), Tables 48 and 49.

Note: Data reflect benefits provided to full-time permanent employees. Detail may not add to totals because of rounding or because the specific provision was indeterminable.

[a]Data are for 1986, and exclude 11 percent of participants in plans which continue access to coverage after retirement other than that required by federal law (COBRA), but to which the employer does not contribute. Estimates assume that specific benefit provisions are proportionately distributed among plans to which the employer does contribute.

[b]Data are for 1987. Data on the number of participants with retiree plans to which the employer does not contribute are unavailable.

[c]Less than 0.05 percent.

[d]No plan participants in this category.

[e]Includes employees who participate only in the employer's dental insurance plan and for whom health insurance coverage and provisions are unknown.

Table 2
Number and Percent of Workers in Employer-Sponsored Health Insurance Plans with an Employer Contribution to Coverage After Early or Normal Retirement: Medium-Size and Large Private Establishments by Establishment Size and Industry Group, 1981-1985

Establishment size/ Industry group	1981 Number (in millions)	1981 Percent	1985 Number (in millions)	1985 Percent	Percent Increase in Workers with provision, 1981-85
			Early retirement[a]		
All participants with an employer contribution to retiree coverage	11.2	61.1%	12.8	63.9%	14.3%
Establishment size:					
100 - 249	0.8	39.3	1.1	46.2	37.5
250 - 499	1.6	45.7	1.6	40.6	b
500 - 999	2.4	61.3	2.2	63.4	-8.3
1,000 - 2,499	2.4	64.8	2.8	72.5	16.7
2,500+	3.5	73.2	5.0	80.7	42.9
Industry group:					
Manufacturing	6.3	59.7	7.3	64.4	15.9
Nonmanufacturing	4.8	63.2	5.4	63.3	12.5
			Retirement at age 65[c]		
All participants with an employer contribution to retiree coverage	10.0	55.0	11.8	58.9	18.0
Establishment size:					
100 - 249	0.8	39.3	1.0	42.6	12.5
250 - 499	1.3	37.1	1.5	36.4	15.4
500 - 999	2.2	55.5	1.9	54.2	-13.6
1,000 - 2,499	2.2	58.7	2.6	67.3	18.2
2,500+	3.2	67.9	4.8	76.8	50.0
Industry group:					
Manufacturing	5.6	52.4	6.7	59.1	19.6
Nonmanufacturing	4.5	58.6	5.0	58.6	11.1

Source: Michael A. Morrisey and Gail A. Jensen, "Employer-Sponsored Post-Retirement Health Benefits: The State of Knowledge and Some Unresolved Issues," University of Alabama at Birmingham, working paper (September 1988); and Gail A. Jensen, unpublished tabulations of the U.S. Department of Labor Employee Benefit Survey, 1981 and 1985.

Note: Detail may not add to totals because of rounding.

[a]Data include workers with coverage that continues at least until age 65; workers with some other limited period of continuation are not included.

[b]No measurable change.

[c]Data include only workers with coverage that continues indefinitely; workers with a limited period of continuation are not included.

Table 3
Number and Percent of People Age 55 or Older
with Retiree Health Insurance by Age, 1984

Retiree age	Number[a] (in millions)	Percent within age group	Percent of all people with retiree health insurance
Total	11.3	23.6	100.0
Age 55-59	1.2	10.2	10.2
Age 60-64	2.6	24.4	23.1
Age 65-69	2.9	32.9	25.2
Age 70-74	2.1	30.0	18.8
Age 75+	2.6	26.3	22.6
Summary:			
Under age 65	3.8	17.1	33.4
Age 65 or older	7.6	29.6	66.6

Source: Preliminary EBRI tabulations of the Survey of Income and Program Participation, matched Waves 2 through 5 (U.S. Department of Commerce, Bureau of the Census).
Note: Data omit individuals living in households that were not interviewed at any time during the calendar year. Items may not add to totals because of rounding.
[a]Includes primary-insured retirees and people with dependents' coverage.

Table 4
Percent of People Age 65 or Older with Health Insurance
from Selected Sources, by Age, 1984

Source of coverage	Total, Age 65+	Age 65-69	Age 70-74	Age 75+
Active worker coverage from a current employer	8.5%	16.4%	7.2%	2.5%
Direct[b]	5.6	10.4	5.1	a
Dependent's coverage[c]	2.9	6.0	2.1	a
Retiree coverage from a past employer	29.6	32.9	30.0	26.3
Direct[b]	23.7	24.7	23.6	22.9
Dependent's coverage[c]	5.9	8.2	6.4	3.4
Other private insurance	54.8	48.6	58.2	57.9
No private insurance	38.1	31.7	36.3	45.1

Source: Preliminary EBRI tabulations of the Survey of Income and Program Participation, matched Waves 2 through 5 (U.S. Department of Commerce, Bureau of the Census).
Note: Data omit individuals living in households that were not interviewed at any time during the calendar year. Items may not add to totals because of rounding.
[a] Statistically insignificant.
[b] Includes people with survivors' coverage and those who report both direct and dependent's coverage of the same type.
[c] Excludes people with both direct and dependent's coverage of the same type.

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Table 5
Number and Distribution of People with Retiree Health Insurance, by Family Income and Age, 1984

Family Income	Recipients Under Age 65		Recipients Age 65 or Older	
	Total[a] (in millions)	Cumulative percent of beneficiaries	Total (in millions)	Cumulative percent of beneficiaries
less than $10,000	0.5	11.7	1.2	14.8
$10,000 - $14,999	0.7	29.2	1.5	35.2
$15,000 - $19,999	0.7	46.7	1.6	55.8
$20,000 - 24,999	0.4	63.8	1.2	70.2
$25,000 - $29,999	0.5	76.2	0.7	79.4
$30,0000 - $39,999	0.5	88.3	0.8	89.7
$40,000 or more	0.5	100.0	0.8	100.0

Source: Preliminary EBRI tabulations of the Survey of Income and Program Participation, matched Waves 2 through 5 (U.S. Department of Commerce, Bureau of the Census).
Note: Data omit individuals living in households that were not interviewed at any time during the calendar year. Items may not add to totals because of rounding.
[a]Includes only retirees ages 55-64.

Table 6
Number and Percent of People Age 55 or Older with Retiree Health Insurance by Type of Pension Plan Sponsor[a] and Recipient Age, 1984

Recipient Age	Total with retiree health coverage (in millions)	Percent with pension income			Percent with no pension income
		Total[b]	Private pension	Public pension[c]	
Total	11.3	79.8%	50.2%	29.7%	20.2%
Age 55-59	1.2	78.7	44.7	34.1	21.3
Age 60-64	2.6	82.3	54.5	27.8	17.7
Age 65-69	2.9	82.1	54.0	28.1	17.9
Age 70-74	2.1	79.2	49.6	29.6	20.8
Age 75+[j]	2.6	75.8	44.4	31.4	24.2
Summary:					
Age 55-64	3.8	81.2	51.4	29.7	18.8
Age 65+	7.6	79.1	49.5	29.6	20.9

Source: Preliminary EBRI tabulations of the Survey of Income and Program Participation, matched Waves 2 through 5 (U.S. Department of Commerce, Bureau of the Census).
Note: Data omit individuals living in households that were not interviewed at any time during the calendar year. Items may not add to totals because of rounding.
[a]For people with only dependent's coverage from a spouse's plan, the spouse's pension plan sponsor is reported.
[b]Also includes military pensions and other pensions from unspecified sources.
[c]Federal, state, or local government employee plan. Category excludes military pensions.

Table 7
People Age 55 or Older with Retiree Health Insurance
by Level of Retiree Contribution to Coverage,
Type of Pension Plan Sponsor, and Retiree Age, 1984

	Number of retirees with benefit (in millions)	Share of plan cost paid by retiree: All	Part	None
		(percent of participants)		
All retirees	11.3	21.9%	39.3%	38.8%
Age 55-64:				
Total	3.8	19.3	42.2	38.5
Pension sponsor:				
Private	2.0	14.3	36.4	49.3
Public	1.1	19.1	60.2	20.7
Not reported	0.8	33.4	29.6	37.1
Age 65+:				
Total	7.6	23.2	37.9	38.9
Pension sponsor:				
Private	3.9	14.8	34.0	51.2
Public	2.2	22.4	54.4	23.3
Not reported	1.7	44.3	23.8	31.9

Source: Preliminary EBRI tabulations of the Survey of Income and Program Participation, matched Waves 2 through 5 (U.S. Department of Commerce, Bureau of the Census).
Note: Data omit individuals living in households that were not interviewed at any time during the calendar year. Items may not add to totals because of rounding.

Table 8
Private and Public-Employer Liability for Retiree Health Insurance Benefits:
Intermediate Estimate, Discounted Present Value, 1988[a]
(dollars, in billions)

Worker/Retiree Status	Private Employers	Public Employers	Total
Current retirees	$ 68.2	$ 23.0	$ 91.2
Current workers	100.5	87.7	188.2
Total, retirees and current workers	168.7	110.7	279.4

Source: Employee Benefit Research Institute, preliminary estimate.

[a]Estimates include reductions in plan cost as a result of recent legislation expanding Medicare benefits. On average, corporate and public-employer liabilities are estimated to decline by approximately 30 percent as a result of new Medicare benefits.

Mr. ANTHONY. Thank you for your testimony.
Mr. Dopkeen.

STATEMENT OF JONATHAN C. DOPKEEN, PH.D., MERCER MEIDINGER HANSEN, INC.

Mr. DOPKEEN. Thank you. My name is Jonathan Dopkeen. I am a consultant with Mercer Meidinger Hansen in Chicago, and I specialize in retiree medical benefits.

I am here in two roles, and primarily as a policy researcher who have worked extensively from an academic approach on postretirement health benefits, and more recently as a consultant to employer sponsors of these plans.

You are going to hear today, and you have already started hearing, about rising costs of health care attributable to inflation, utilization, technology, the increasing cost shifting by Medicare and also employers. You will hear about the hardening liabilities, not only attributable to court decisions, but also to the forthcoming FASB rules. And you will certainly hear, and have already started to, about how you ought to restore tax incentives, dismantled under DEFRA, to secure retiree health benefits in the future. And barring this, you may hear that retirees may lose their benefits. Indeed, I think all these constitute a critical situation.

The problem I think should be defined a little more broadly. It is not that current retirees will lose their benefits, although some may. The courts have generally seen to that, except in issues of employers' survival.

The real crisis is in the not too distant future, and it has two dimensions. The first is an increasing number of retirees that we are about to see, much greater than numbers that we have now. By the year 2010, we will see an unprecedented demand for medical services, and there is a question as to what kinds of protection will exist.

The second dimension is the question of what the future role will be for corporations in retirement. And I am suggesting that, both from my research and my perspective as a consultant, I believe that retiree medical issues are going to be the basis for the reevaluation of the corporate position on how it is going to be involved with retirement. This is attributable to the extraordinary and even unknown dollars, and with the consequence of a widespread, potential for retrenchment in corporate benefit plans generating a greater demand for public and individual expense.

The key issue confronting you, I believe, is how to resolve the conflict between looking for retiree security and employer security.

I was asked here as a policy researcher and historian of this issue. I would like to give a brief overview that I hope will help address policy questions, such as the stabilization or prefunding of retiree health benefits.

These benefits are provided not simply by the older smokestack industries where the concentration of liabilities may be heaviest, but they are offered widely across sectors, and, furthermore, not simply by the biggest but by moderate and smaller sized plans as well. In total, well over a quarter now, and I just heard a higher estimate, of the over 65 population has access to employer-spon-

sored plans. Well over that, my estimate was a third of the private work force today, is working in firms that currently offer the benefits.

The nature of the benefit should be important to whatever course you take. There is a high degree of variability, perhaps half of the plans are noncontributory for retirees, perhaps somewhat less than that for retiree spouses, with levels varying by size.

There are several different plan types that vary widely in how they relate and wrap around Medicare. In a sense, there are many different promises out there and not a uniform one at all.

The most compelling feature of retiree health benefits, I believe, is their egalitarian form. These are unlike any other retirement benefit in that they are not based on or related to wages. They disproportionately benefit low wage and shorter service retirees. Whether it was intended or not, it is a benefit that is highly egalitarian.

An historical perspective briefly might hold some suggestion as to what employers may do, and also clarify what the roles were in getting into this situation.

These benefits began in the 1950's, and they were negotiated. Prior to Medicare, perhaps as many as 60 percent of the collectively bargained plans already had forms of retiree medical benefits. This reflects corporate adaptation, I think, to a complex environment that had pressures. They reflect the unions who were seeking not only increased compensation but to obtain welfare functions that were too expensive for them to provide to members. There were pressures from the insurance industry which, in seeking to forestall Medicare, sought to look for efficient and economic employed groups to cover. And it reflected, indeed, pressures that employers felt themselves in seeking to manage, through the use of retirement, their work forces and to obtain cooperation and loyalty in competition with unions. Indeed, all of this was done in the presence of tax incentives, which encouraged welfare plans.

There were few retirees; the costs were low, and health care costs were low relative to active employees. It was an easy thing to do.

There were warnings prior to Medicare that prefunding was required. The Curtis bill in 1964, which became the 401(h) later, was passed. Then Medicare was passed and relieved liabilities of the employers, truly leading this to become an incidental benefit. After Medicare, benefits spread widely across the larger employers competitively, and then down into more and smaller employers as insurers moved to secure the available market that was easier to insure. This resulted in the wide variability in plans.

Given this history, and with the public policy of tax incentives in place, it becomes understandable why corporations have not funded the plans. Even ERISA, as we mentioned previously, recognized in 1974 post-employment welfare benefits, but did nothing to insure their delivery.

In that same year, health care costs began to spiral out of control and, indeed, had it not been for Medicare, we might have had this hearing in 1975.

Briefly, what's useful? I think, there are four points just to draw out of this history immediately. The first is that FASB's conclusion

of deferred compensation is historically sound. The second is that the benefits are broadly based, not simply since Medicare was in place, but there is a substantial tradition that extends almost to the beginning of employer-bargained health plans.

Third, this was an adaptive response by corporations to an environment. Not only did retiree health benefits respond to the interests of the people and the organizations, such as unions that were bringing pressures on the corporations, they responded largely to the interest of corporations also. Providing retiree health was highly utilitarian to do.

Lastly is that there was a public policy role. This included tax incentives that were in place encouraging plans; Medicare's program, past and present; and also the exclusion under ERISA that did not recognize the benefits as material. All contributed as much as employers did to the establishment of these plans.

In conclusion, I would like to say I think there are other implications in the history for anticipating what the future responses of employers may be and what the shape of benefits to come is, but that is beyond my time.

Thank you.

[The statement of Dr. Dopkeen follows:]

EMPLOYER-SPONSORED RETIREE HEALTH PLANS

JONATHAN C. DOPKEEN, PH.D.
MERCER MEIDINGER HANSEN, INC.

TESTIMONY SUBMITTED TO THE SUBCOMMITTEE ON OVERSIGHT,
COMMITTEE ON WAYS & MEANS,
U.S. HOUSE OF REPRESENTATIVES,
SEPTEMBER 15, 1988

My name is Jonathan Dopkeen. I am a consultant with Mercer Meidinger Hansen, Inc. in Chicago, and I specialize in retiree medical care. I have recently joined Mercer after completing academic research on the policy aspects of postretirement health benefits. I therefore find myself here in two roles, first for my research on retiree health benefits, and second as a consultant to the sponsors of retiree medical benefits. While my firm supports my appearance before you today, my testimony represents my own positions.

Today's hearing is on the availability of employer-sponsored retiree medical plans, their associated liabilities, and the factors that may impact their continued availability. My research has focused on what employers who sponsor retiree health plans may do in this very volatile environment, and why.

You will hear much today about the factors driving the crisis. The costs of these medical benefits are rising due to inflation in health services and to increases in the utilization and technology. You may hear about cost-shifting by Medicare and employers, and the hardening liabilities attributable to court decisions and the new accounting rules forthcoming from FASB later this year. You may hear that you should restore the tax incentives, removed under DEFRA, to prefunding these benefits in order to secure them in the future. You may hear that, barring this, retirees who have counted on these benefits will lose them. These factors do constitute a critical situation.

The crisis that I envision, however, is broader. It is not that current retirees will lose their benefits, although some may. The courts have largely seen to the continuation of committed benefits, providing that an employer survives. The real crisis, in the not too distant future, has two dimensions. One is that there are increasing numbers of people who will retire in the future, many more than are currently retired. The baby boom generation will create by 2010 an unprecedented demand for medical services that cannot possibly be met by our current system. Therefore, what kinds of protection will be available to safeguard the retirement income security of future retirees is the first dimension of this crisis. The second is the future of the corporation's role in retirement security.

I suggest that the question of retiree medical benefits is the issue on which corporations are going to rethink the extent and the scope of their future role in retirement security. This is not an ordinary benefits issue because of the unprecedented and unknown dollars involved. Widespread corporate retrenchment and greater demand for public expenditures may be the consequence.

THE MAIN QUESTIONS

The problem today is being brought home by the liabilities that now will be measured by the FASB rules. Even without the accounting implications, the very costs of the benefits on a pay as you go basis have destabilized the benefit's future. As with pensions, the only way to guarantee the benefits in the future is to develop and set aside funded reserves.

The key issue to resolve is the conflict between retiree security and employer security. Employers and retirees alike are in search of certainty and security. It would seem that more security and certainty for one means less for the other, unless we find ways to adequately fund and secure the benefit.

Several questions are of concern. Who is providing these benefits, and who has been promised them? Who made the promises, and what was the nature of the promise? It is true that employers and not Congress promised the benefits. Why then should you provide tax incentives to enable those promises to be kept?

You have asked me here as a policy researcher and historian of this issue. I hope that an overview of the benefits and an historical perspective will help you to address the policy questions associated with the stabilization or prefunding of retiree health benefits.

WHO PROVIDES RETIREE HEALTH AND WHO RECEIVES THE BENEFITS?

Until recently, the perception widely held was that employer-sponsored retiree health benefits were provided mostly by the older smokestack industries, which are heavily unionized and have high ratios of retired to active workers. While it is true that that is the sector with the greatest concentration of liability for current retirees, the benefit is offered widely across virtually all of the sectors including manufacturing, communications, transportation, sales and services, although the prevalence and richness among sales and services are lower.

Furthermore, the benefits are provided not only by the biggest, but by moderate and smaller sized firms as well. Indeed, it is offered by many firms that will not necessarily be well represented by the largest firms that you will be hearing from.

In total, my research has shown that perhaps more than one-fourth of Americans over the age of 65 have access to postretirement health benefits provided by employers, both private and public. About one third of the private work force today is employed in firms that provide retiree medical benefits, although they may not see those benefits by the time they retire.

Quite apart from the contributing factors already cited, there are other reasons why these benefits are eroding. These include changing job patterns; jobs growth today is generally in firms without these benefits. Increased job mobility suggests that many will never receive these benefits. The increased numbers of women in the work force may diminish the numbers of future retirees who successfully vest in the benefits, just as in pensions. Therefore, even before some employers defensively begin to reduce the scope or availability of their retiree plans, and were all the other contributing factors controllable, there might still be debate over the preservation and future of these benefits.

THE NATURE OF THE BENEFIT

The high degree of variability of retiree health benefits by employers is significant. About half of the plans offered by the largest employers are noncontributory for retirees, and somewhat less than half are noncontributory for their spouses. A larger proportion of moderate and smaller plans require contributions. Nearly all (95%) provide spouse coverage, and most extend coverage to those over 65 complementing Medicare. There are several distinct types of plans which wrap around Medicare. They do so in different ways, and provide very different levels and types of coverage. There are also cash plans. When you delve into the promise, it becomes clear there are many different promises out there.

In spite of its variability, the most compelling feature of retiree health benefits are their egalitarian form. These benefits are unlike any other vehicle for retiree security. Pensions are entirely based on the labor market principle of earned equity; an individual's retirement is a function of earnings and years of service. So too are Social Security payments. Employer-sponsored capital accumulation plans are also linked to earnings. In contrast, retiree health benefits have traditionally not reflected market differentials in either earnings or duration of service.

Within a firm, although there may be different plans covering hourly or salaried workers, the benefits are generally egalitarian. The low-wage worker and the vice-president are generally eligible for the same benefits. It may be, in practice, that the retired vice president goes to the Mayo Clinic while the low-wage retiree goes to the local hospital, but the eligible benefits are generally the same. Upon examination of the relative actuarial values provided under pensions and retiree medical, retiree health benefits disproportionately favor both low-wage workers and shorter-service retirees. Whether or not this was the intended result, the benefit today is highly egalitarian.

AN HISTORICAL PERSPECTIVE

My research has taken me into the history of retiree medical benefits, to find out whether in their development there might be a better understanding of the nature of the benefits, and clues or predictors of what companies might do in the future. There are elements in the history that are instructive, and I would like to briefly share these with you. It may also help clarify roles and responsibilities.

Retiree health benefits did not start with Medicare. They developed in the 1950s, following closely behind the introduction of health coverage for active employees. At a recent conference on retiree medical benefits, a question before our panel was "Did management give away the shop?" My answer was "No, it was negotiated." Before Medicare was enacted, nearly 60 percent of the major collectively bargained plan had retiree medical benefits in some measure.

The pre-Medicare history reflects an intricate and incremental adaptation by corporations to their environment. In that environment there were pressures from unions, insurance companies, the employers' own needs and the presence of tax incentives encouraging welfare plans. Unions pressed for increased compensation through retirement benefits because they were financially unable to sustain the welfare function of supporting aging workers. The insurance industry sought to reach an insurable and efficient market through employed groups; the objective was to forestall the federal intervention which became Medicare. Employers needed to manage their work forces by making retirement attractive, and to compete with unions for the loyalty and cooperation of their workers. The presence of tax incentives to encourage employer-provided welfare benefits made retiree health benefits an expedient concession. There were few retirees at the time, the costs of health care were low, and the costs for retirees relative to those of the active workers were incidental.

Retiree health benefits spread extensively through the largest employers and then downward to smaller employers in the several years following Medicare's enactment, as the insurance industry moved to secure the remainder of the group market for the elderly. This expansion accounts for the wide variability in plans today. The collectively bargained and larger plans had coverage that exceeded Medicare's, resulting in "carve-out" and "coordination of benefit" plans. "Supplement" plans were gap-filling around Medicare, and the wider prevalence of variable contributions reflected the adoption by smaller and more moderate sized companies of affordable plans specifically tailored by the insurance companies.

There had been warnings to prefund retiree health and life insurance benefits before Medicare. Quite responsibly, Congress had passed the Curtis Bill in 1964 which provided for the advanced tax-favored funding of postretirement medical benefits subject to the pension fund, and which appears to have been the forerunner of the 401(h). Had it been used the problem would be smaller today. Medicare then apparently, however, relieved employers of the significant portion of potential expense under the plans, and subsequently few employers were concerned about a developing liability. Retiree health truly became "the incidental benefit."

Given this history, together with the public policy of tax incentives to promote employee welfare and the new federal Medicare program, why employers neglected to prefund retiree benefits becomes more understandable. This was also reflected in public policy. Congress, in bringing greater security to pensions with ERISA in 1974, recognized postemployment welfare benefits in the act. Their provision was not similarly ensured, however, because the benefits appeared immaterial. In the same year, 1974, health care costs began to soar out of control. Had Medicare not been enacted a decade earlier, it is likely that all of us, or our predecessors, might have been sitting in a similar hearing in 1975.

What from this history is useful today? There are several points. First, the FASB's conclusion that retiree health benefits are deferred compensation is historically sound. They evolved from deferred compensation, clearly tied to wages negotiated in the labor market, into an egalitarian entitlement.

Second, the benefits are broadly based, and have a substantial tradition and role in the package of employer-provided welfare security retirees have come to rely on.

Third, retiree health benefits were provided as an adaptive response by employers to a complex environment characterized by pressures from organized labor, the insurance industry, the competitive needs of the employers themselves, and in response to tax incentives. Employers did it because it was in their interests, as well as the interests of others.

Fourth, the use of tax incentives to encourage employers to meet social welfare needs of their workers, the Medicare program past and present, and even the exclusion of postemployment welfare benefits under ERISA would suggest that public policy has contributed, along with employers, to today's situation.

Mr. ANTHONY. Thank you, Dr. Dopkeen.
Our next witness will be Mr. Gold.

STATEMENT OF JEREMY GOLD, PRINCIPAL, MORGAN STANLEY & CO., INC., NEW YORK, NY

Mr. GOLD. Chairman Pickle, members of the committee, thank you for the opportunity to appear before you today. My name is Jeremy Gold. I am a principal of Morgan Stanley & Co., Inc., in New York, where I head our pensions group. Morgan Stanley is a full-service global investment banking firm committed to providing innovative financial services for our clients. Corporate services are broadly divided between raising capital and advising on financial matters. The firm also has important capabilities in investment research, asset management, and trading in all major types of securities.

Because pension plans represent an important component of a firm's financial operations, Morgan Stanley pensions was formed to serve our clients' pension needs. We meet these needs with a consultative approach, offering a broad range of products and service to help plans and their sponsors. Working with Morgan Stanley's corporate finance, research and execution groups, we continually develop new strategies for plan sponsors and investment managers.

By training I am an actuary. I'm a fellow of the Society of Actuaries, a member of the American Academy of Actuaries and Conference of Actuaries in Public Practice. I am an enrolled actuary under ERISA. I offer these credentials primarily as identification. I speak for myself only and not on behalf of these organizations.

You have asked me to discuss the investment community's reaction to the accounting statement which the FASB will promulgate with respect to the accounting for postretirement medical benefits. I have a few brief comments organized into four areas. These areas are credit research, equity valuation, merger and acquisition, and prospects for funding and related tax issues.

CREDIT RESEARCH IMPLICATIONS

There are a number of services which evaluate the creditworthiness of fix income securities. The major rating agencies monitor issues and classify securities into general ranges. Credit Research Departments of large investment banks provide indepth analysis to supplement the work of the rating agencies by differentiating credit within classes and by trying to identify trends leading to possible credit upgrades or downgrades. Institutional investors use these services to identify values available in the marketplace and opportunities to enhance returns on the portfolios they manage.

Discussions with our credit research experts lead me to believe that the new accounting rules will have minor impact upon the valuation of existing fixed income assets and upon the ability of borrowers to raise new capital in the debt market. The primary focus of most credit analysts is on cash flow considerations regarding the issuer's ability to service its debt. In general, a change in accounting rules will not change current or anticipated cash flows. In addition, credit analysts already have an awareness of those industries which have substantial postretirement medical liabilities,

such as the steel industry, and factor this into the credit analysis. it is the expectation of our analysts that only major surprises, where reported liabilities substantially differ from expectations, will create changes in credit valuations.

EQUITY RESEARCH IMPLICATIONS

Now, I have been talking about the fixed income market. The equity market is somewhat different. The role of an equity analyst is more complex than that of a credit analyst because he must attempt to value the ownership portion of a corporation on an ongoing basis. This involves analysis of macroeconomics, industry trends, competition at home and abroad, labor and productivity issues, and management skills. All of this is factored into making long-term earnings projections which are valued on a risk adjusted discount basis to determine a present value of projected dividends and earnings.

In general, equity analysts believe that they will be able to restate reported earnings to adjust for the impact of new accounting rules and compare them to expected earnings using their traditional valuation methods. However, the new accounting rules are likely to reduce reported corporate earnings. To the extent that these earnings reductions have been anticipated, equity prices may remain constant while the price earnings multiple would then expand.

Unanticipated earnings reductions would not result in expanded multiples but rather in price reductions. Those who analyze individual equities are likely to have a good sense of this earnings impact and thus will anticipate it. These analysts, however, are not necessarily the same people who compare earning streams or dividend streams to alternative investments such as bonds or foreign equities.

Quantitative analysts and asset managers are less likely to anticipate, and their computers less likely to ignore the drop in reported earnings. They will tend to conclude that equity prices are too high relative to bond prices and will, on the margin, sell equities to buy bonds.

To the extent that the accounting for non-U.S. companies does not change, or to the extent that investors do not perceive a medical liability burden on those equities, investors may sell domestic equities to buy foreign equities.

The sale of domestic equities to buy bonds and non-U.S. equities will raise the cost of capital for U.S. corporations, both in absolute terms and relative to their foreign competitors.

IMPACT IN THE MERGERS AND ACQUISITION ARENA

Turning now to mergers and acquisitions. The sale of a company or division usually involves the negotiated transfer or retention of pension and postretirement medical benefit assets and liabilities. Although there may be a wide range of valuations, as we've seen today, given the uncertainty of medical inflation, better focus is given to these liabilities during such a transfer than through the ongoing credit or equity research process. Because the level of attention to these issues is already high, particularly for transactions

involving older industrial companies, the new rules are unlikely to have a significant impact in this arena.

PROSPECTS FOR FUNDING AND RELATED TAX ISSUES

Finally, with respect to the funding and related tax issues. The new accounting rules will bring increased focus on postretirement medical liabilities. This will probably encourage corporations to reduce benefit promises and/or transfer benefit costs to their employees. Funding under sections 401(h) and 501(c)(9) of the Internal Revenue Code is not as tx efficient as is pension funding under Sections 401(a) and 404, and thus there is insufficient incentive for most companies to prefund medical liabilities. The new financial account standards may increase the desire of some firms to fund, but this interest is likely to remain marginal in the absence of tax effectiveness. If, however, the Internal Revenue Code were amended to allow prefunding on a basis comparable to that used for pensions, many sponsors would be inclined to fund, even in the absence of a funding mandate.

The success of pension plan investments, and more market-oriented valuation of pension liabilities, has caused companies to recognize substantial pension surpluses at the same time as the new accounting rules are causing them to recognize new unfunded liabilities. Many sponsors feel that an obvious way to deal with these two issues would be to apply pension surpluses to medical liabilities. The current tax impediments to this approach have discouraged sponsors.

Tax efficient funding of postretirement medical liabilities will encourage U.S. corporations to provide monies today to meet their employees' expected medical needs in the future. In the absence of tax effective funding, the new standards are likely to accelerate benefit reductions and cost shifting to employees. This in turn will leave older Americans underprotected and increase demands on Medicare and other governmentally sponsored health care systems. Tax incentives today should be cheaper and more efficient than governmentally supplied benefits tomorrow.

Thank you for the opportunity to share my views with you. This is an important and complex area of public policy. We look forward to these hearings leading to positive action.

Thank you.

Mr. ANTHONY. Thank you, Mr. Gold.

The next witness would be Mr. Dankner.

STATEMENT OF HAROLD DANKNER, PARTNER, COOPERS & LYBRAND, WASHINGTON, DC

Mr. DANKNER. Thank you. My name is Harold Dankner, and I am a partner with Coopers & Lybrand, and the technical director of our benefits consulting operations.

I am the individual who is responsible, as a partner in Coopers & Lybrand, for conducting the field test of the forthcoming FASB exposure draft on retiree health benefits that is being sponsored by the Research Foundation of the Financial Executives Institute. I will briefly comment on the field test in a few moments.

This morning you have heard a fair amount about statistics, and certainly it is reasonably clear that the unfunded obligations for employer commitments relating to retiree health benefits are significant, whether the number is $200 billion or higher or lower, the number is certainly large and the coverage is broad.

Most large corporations provide some form of retiree health benefits, and a surprising number of companies with even under 100 employees have some form of retiree health benefit.

The issues and statistics are of great concern to employers, the Government, employees, as well as retirees. What I would like to focus on this morning concerns what is behind the numbers, why are they what they are, and the field test effort.

In dealing with what the numbers are, I think it's most important to first look at the nature of the benefit promise, and try to do some comparison with the pension promise.

First, as to the nature of the promise, it is usually expressed in words, not in dollars. Effectively the companies have promised coverage normally for a lifetime for the retiree and often for the lifetime of the spouse. The spousal benefit is generally a concurrent benefit, in other words, payable for the lifetime of the spouse once the employee retires.

Eligibility and accrual. Basically when the employee is eligible to retire, he or she would become eligible for the benefit. The act of retirement would lead to entitlement to the benefit. This is very different from pensions. We have standards dealing with pensions as to how individuals are eligible and how the benefits are accrued. In the case of a retiree health promise, it is all accrued at one moment. It is not accrued ratably over the lifetime of the employee as is generally the case with a pension benefit.

Costs are much harder to predict for a variety of reasons, not just predicting how much the health care cost trend will be, but to deal with the starting point, how do you convert the word "promises" to "dollars" in order to make an estimate of what those obligations will be and how you would spread them as a cost.

Another important difference is funding. These promises have been unfunded. There are very few corporations that have done any advanced funding of the retiree health promise unlike the situation for pension plans.

The FASB has a major project and, in the very near future, will be issuing an exposure draft, and this is what we are testing in the field test. The Financial Executives Research Foundation, recognizing that accounting is in an evolutionary stage, has sponsored a field test, and the objective of the field test is to provide the FASB, the field test companies and other interested parties with important analytical data on exactly how this proposal would work, what would the results be, identifying measurement and implementation concerns.

In order to accomplish this, we have 25 companies participating in the field test. We have collected detailed information about their plan promises, about their demographics—who the promises have been made to, as well as medical claims information in order to establish a starting point to make these actuarial projections or estimates.

We will be furnishing each field test company with a detailed report of exactly how the standard would work and what the results would be, projecting cash flows, obligations or liabilities under the proposed standard, and accrual expense.

In performing this work, we will also provide analysis in a forecast mode, what the expense would be out in the future, not just for the single point in time. We will also provide comparative analyses in terms of what is the current expense on a pay as you go basis versus what it would be under the standard, analyzing why the numbers are what they are and what they are sensitive to.

To perform these projections, we have matched retiree claims information with the retiree demographic data in order to get a starting point to establish baseline costs to do the projections. It is a process that involves converting effectively the word "promises" to "dollars" in order to make projections.

We have encountered a series of problems concerning availability of data that Jim and Diana alluded to in their testimony. One basic point on claims information—if you cannot separate the claims information for retirees and active employees, it would be very difficult to project what the obligations would be since the claims experience is quite different. It is not just different once somebody reaches age 65. If you examine the claims experience and utilization of a retiree under age 65, and compare it with an active worker under age 65, and you do it for a group, you will find the retirees utilize health care far more than the active employees.

Therefore, having a good starting point is important, and having sound claims information to do the projections is necessary.

Another key area is demographic information. The cost of a lifetime spousal benefit is at least as much for most companies as the cost of the benefit for the retiree. Accordingly, it's critical to have good spousal information to know exactly who would be receiving the benefit.

Another very important point in examining the numbers are the assumptions. How did you develop your baseline costs and what is the trend rate that you're growing them? Since the benefit isn't expressed in dollars, you must have a starting point to make projections. The trend rate that you use to grow those benefits, as well as how you discount those benefits, has a significant effect in the answer.

Another key area is how long a period you use to amortize the costs. Is it over an entire career or a shorter period?

The final area of concern, as the FASB clearly has recognized and talked about today, is transition. How do you get started when you have all of these unfunded obligations? Over what period are you going to amortize them? And what is the interest factor on that transition obligation? This is very important as to how high the level of expense will be.

All of these factors that I've mentioned have a significant influence on the answer—the numberes. In other words, the answer could be when you're looking at accrual expense possibly two or three times the pay as you go number, five or six times, or even higher, depending upon how these important issues are addressed.

Finally, in looking at what's behind the numbers, whether the unfunded liabilities are $200 billion or higher, or whether expense

under an accrual standard would be four times pay as you go or two times pay as you go, it's critical to recognize that the actuarial measurement issues and the accounting for these benefits are only small parts of an overall puzzle. The real dilemma is, who is going to pay for these benefits? You have three sources—the Government, the individual retirees and companies. And it has become clear, in working for a lot of companies, the companies don't want to pay it, the Government isn't very anxious to take on additional obligations, and the retirees would certainly have the other two parties pay.

Regardless of who succeeds in cost shifting, whether the Government to the private sector, or retirees to companies, or vice versa, this doesn't stop overall increases in health care costs. It just shifts costs from one party to another.

Any legislative initiatives, it seems to be, cannot be purely revenue driven. They have to look at the issues of benefit security, and there has to be a legitimate balance in terms of what role the Government would play, as to access to health care, as well as any subsidies that are provided in the way of prefunding.

Employers are going to want—and I think it's critical—will need to retain flexibility in managing these programs, their ability to modify the programs, and to try to control costs and provide a benefit that they can realistically afford.

Perhaps the ultimate question isn't whether there's a need for quality health care for a growing number of retirees, it's how do we equitably and affordably distribute these costs among the interested parties, how much can America afford to spend on overall health care costs out into the future and have a competitive work force and competitive companies.

Thank you.

[The statement of Mr. Dankner follows:]

Written Statement of Harold Dankner, Partner, Coopers & Lybrand, Washington, D.C. Before the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, Hearing on Employer - Sponsored Retiree Health Insurance, September 15, 1988.

Mr. Chairman and Members of the Subcommittee, I am pleased to submit these comments to accompany my testimony, and I commend the Subcommittee's efforts to review the issue of retiree medical benefits, an area that will be of growing concern in the coming months and years. I am submitting this statement on behalf of my firm, Coopers & Lybrand, an international accounting firm with an extensive actuarial and employee benefits consulting practice.

The statistics on retiree medical benefits are staggering: over 85 percent of the largest U.S. companies provide these benefits to their retirees. However, approximately 40% of the nation's small employers - those with 50 to 99 employees - also provide some form of medical benefits for retirees. In fact, it has been estimated that 75% of the current workforce has received an indication that they will receive some health care benefits at retirement. Nationwide, employers' unfunded retiree medical benefit obligations have been estimated from $100 billion to $2 trillion, and several companies have unfunded obligations exceeding $1 billion each. This issue clearly affects employers, both large and small, current retirees and those now in the workforce concerned with the security of their health benefits at retirement.

In order to deal reasonably and creatively with these substantial obligations, it is vitally important to understand what is behind the numbers -- what do the statistics represent and how are they derived?
Retiree medical benefits usually commence at the same time as an employee's pension, at retirement. However, there is really little other similarity between pension and retiree medical benefit plans, and it is often inappropriate to apply pension plan concepts to retiree medical benefit plans. Traditional retiree medical benefit plans promise, in words, to provide a certain level of medical coverage for retirees. For example, an employer's plan may promise to pay reasonable claims not covered by Medicare, subject to deductibles and coinsurance. In contrast, pension plans usually express a promise in numbers; for example, an employer's plan may provide a pension of 35 percent of a retiree's final average pay.

The following chart summarizes some of the other differences between benefits under qualified pension plans and retiree medical plans:

	Pension Benefits	Retiree Medical Benefits
Eligibility for Benefits and Benefit Formula	Determined by a definite formula, often based directly on length of service or final salary	Generally available for all retirees; Heavily influenced by Medicare and other factors; Not precisely determinable benefit and accrues all at once
Early Retirement	Reduced pension	No reduction in benefits (May cost more until age 65, when Medicare assumes some of the costs)
Beneficiaries	Death benefits after participant's death	Spouse usually receives benefit for lifetime
Benefits	Subject to legal minimum distribution rules and maximums	No maximum or minimum limits

	Pension Benefits	Retiree Medical Benefits
Costs	Employer costs based on economic factors that can be reliably estimated	Employer's health care cost trend more difficult to estimate
Funding	Generally funded	Most pay-as-you-go
Regulation	Subject to ERISA and and PBGC regulatory controls and protection	Currently, no governmental regulation

Because medical benefits are promised in words, the benefit is generally known only if and when an illness occurs. In addition, employers' obligations are affected by rising health care costs and the decreasing portion of those costs paid for by Medicare. Because the employer's obligation is given in words, the employer ends up paying an increasing share of retiree medical costs. An employer's pension obligation, on the other hand, can be more readily estimated, since most variables are keyed into specific numbers. Converting a promise made in words into a number is difficult, and measurement of these programs is complex.

Most companies do not presently record retiree medical obligations on their financial statements, and account for these programs on a pay-as-you-go basis. However, the Financial Accounting Standards Board (FASB) is likely to require accrual accounting for these obligations in an Exposure Draft due out this fall. One of the most difficult issues being addressed by affected companies is how to estimate future costs of health care.

Recognizing that accounting for retiree medical benefits is in an evolutionary stage, the Financial Executives Research Foundation (FERF) is sponsoring a field test on the proposed new accounting standard. Coopers & Lybrand is conducting this field test with a comprehensive study of the plans, demographics and claims costs for 25 participating companies. We will also focus on the numerous measurement issues. The study involves collecting and analyzing data on medical claims, demographics and plan design to project cash flows, obligations and accrual expense associated with retiree medical benefits under the FASB proposal. To understand an employer's obligation, it is important to develop claims experience data which can be projected into the future, taking into account the retiree medical benefits offered, as well as current and future workforce data.
In the field test, we first look at a company's retiree medical costs for a one year period by identifying and analyzing the company's medical benefit plans, both indemnity and HMO options, focusing on retiree eligibility and benefit provisions, including Medicare coordination. Next, we determine the demographic composition of the company's retirees, retirees' dependents, employees and other potential plan beneficiaries, including an analysis of missing or incomplete data. Finally, we capture benefit claims for a one year period and then confirm this data, to make sure that accurate data is used to develop retiree cost projections. This information is used to develop a "baseline cost" for the company.

Various assumptions must then be made to project the baseline cost forward, for example, how much will medical costs increase; how much will Medicare pay; how many employees will leave the company before retirement; how many employees will elect early retirement prior to becoming eligible for Medicare benefits; and how will discount rates be selected. Because the variables affecting an employer's retiree medical obligation are volatile, predicting future costs is imprecise, at best. And, because most companies do not prefund these obligations, selecting certain assumptions, such as the discount rate, is more difficult than it is for pensions, which generally must be funded. In addition, there is no market for these obligations as there is for pension obligations. Insurance companies will issue long-term products, like annuities, for pension obligations, but will not do so for retiree medical obligations.

We are discovering that even very large companies with sophisticated systems have trouble deriving the data necessary to measure their retiree medical obligations. Some of the more common problems encountered in the field test are summarized below.

Claims Information. Traditionally, employers, insurance carriers, or third-party administrators have focused on compiling and storing only the information directly affecting the payment of claims. Therefore, some of the information that would be helpful in determining average per capita costs and in gaining an understanding of the extent of retiree medical benefits has been unreliable, is difficult to extract, or may not even be captured. For example:

- Many of the companies participating in the field test have found that accurate spouse and dependent information for the retiree group is not available or easily accessible as part of the claims data. While claims costs for spouses are generally significant, and non-spouse dependent claims costs may be much smaller for the retired population, this could vary by region, coverage, and company and should be evaluated separately if possible.

- Information as to business unit, salaried versus hourly status, cost center, or plan type is frequently not recorded or not recorded accurately, making it difficult to assign costs to particular employee groups. Because different retiree and employee groups within a company may have different claims experience, aging, and retirement patterns, costs will be segmented in this manner, where appropriate, for purposes of the individual reports to the field test companies.

Demographic Information. Many companies do not maintain information on the age, sex or location of former employees or their spouses or dependents who are eligible in the future for retiree medical benefits.

For example:

- Companies generally do not maintain information on former employees who are eligible in the future for retiree health care coverage. As noted above, it is very difficult to project claims experience, mortality trends, and other assumptions without sufficient data on all covered (including inactive) participants.

- Disabled individuals are frequently not distinguished from early retirees. This may distort baseline costs for the retiree group because disabled individuals often receive larger amounts of health care. In addition, it may be appropriate to utilize different mortality tables for the disabled population.

Once the necessary data has been collected, and obligations projected, participating companies will be able to analyze the effects of the accrual accounting standard on their balance sheets and reported earnings.
As the FASB recognizes, one of the most critical issues in accounting for retiree medical benefits is establishing a workable and reasonable transition from pay-as-you-go to accrual accounting. This is, of course, important because these programs have not been funded. In the FASB's final standard, the period and the amortization method for the transition obligation will have a very significant effect on the level of expense. Obviously, there is a significant difference if expense under the new accounting standard is two to three times what it is under pay-as-you go versus five to six times current expense. Without going into the details of the accounting issues, the important point here is to fairly reflect the transition obligation, by spreading it over a realistically long period of time to have a reasonable answer.

Of course, accounting issues and the field test are only pieces of the retiree medical benefits puzzle. Unfortunately, there are no magic solutions to this puzzle. The basic dilemma involves who will pay for what over the long term: beneficiaries, government or private sector employers. The recent Medicare Catastrophic legislation illustrates this struggle -- beneficiaries will bear most of the costs of enhanced coverage.

In formulating policies to deal with the problem, several basic principles will need to be recognized: First, cost-shifting, whether it be from the government to private industry, from the company to employees and retirees, or from individuals back to employers and the government, does not stop overall increases in health care costs. Second, legislative initiatives should not be purely revenue driven. To tax individuals and corporations to pay for health benefits, or to remove or modify current tax incentives is another form of cost-shifting. There is a delicate balance between the government, employers and individuals concerning how much each can and will pay for an ever increasing health care bill. If employers are to bear the financial burden of paying for and accruing costs for retiree medical benefits, it appears that there should be some associated tax incentives.

Third, employers that provide health benefits for their retirees should retain the flexibility to modify their health care programs to assure that benefits provided are commensurate with the employer's ability to pay, the needs of employees and retirees, and competitive pressures. This flexibility will have to be balanced with the passage of minimum standards to provide benefits security for retirees.

The question is not whether there is a need for quality health care for a growing number of retired employees. The issue, for the government, individuals and employers, is how to most equitably and affordably distribute these costs across our entire society.

Chairman PICKLE. Thank you, Mr. Dankner.

Mr. Dankner, I think I'll ask you first since you just finished with your statement.

You point out that FASB is expected this fall—we hope next month——

Mr. DANKNER. Yes.

Chairman PICKLE. Or at least issue their draft. And you said that is going to be a difficult matter to account for because of the complexity of the problem.

Mr. DANKNER. Yes.

Chairman PICKLE. And that your group is conducting a study now that would determine the—estimate the future cost of health care. I presume you mean retiree health primarily.

Mr. DANKNER. Yes.

Chairman PICKLE. And accordingly you said that your organization is conducting a test with some 25 companies under the FERF program.

When do you expect to issue that conclusion or that study?

Mr. DANKNER. Well, it goes in stages, Mr. Chairman. The first stage is to issue the individual participating companies' detailed reports as to how the standard would work in their situations. We are then taking the individual reports and consolidating them analytically and writing a book.

We expect to issue the individual reports close in time to when the FASB issues their exposure draft. I would say within 30 to 40 days, and then within 3 months we will issue a consolidated report.

Chairman PICKLE. So your report would parallel theirs, plus or minus a short time?

Mr. DANKNER. Yes. The field test is clearly dependent upon——

Chairman PICKLE. How long has your study been underway?

Mr. DANKNER. It's been underway a little over a year in terms of collecting the information and working with the companies.

Chairman PICKLE. Now, you say that employers or companies, whatever health benefits they give their retirees, they should retain some degree of flexibility.

Mr. DANKNER. Yes.

Chairman PICKLE. Now, what do you mean by that? The right to either modify it or change it as they wish or to cancel it, and to back out of it on the snap of the finger?

Mr. DANKNER. No. I think that they need to retain flexibility, yes, as to modifications. As to cancellation, that is another issue. And I think in looking at it—we have looked at generally three groups of individuals—retirees and dependents in pay status, active employees eligible to retire, and active employees not eligible.

I think for the third group, that they should be able to have significant flexibility to modify their promise and perhaps limit their flexibility in the other two situations.

Chairman PICKLE. You contend then that they should have some right to make modifications?

Mr. DANKNER. Yes.

Chairman PICKLE. But not a cancellation. That they should have some kind of basic minimum standards and not be able to just cancel the whole program?

Mr. DANKNER. Well, I think that being able to cancel would be dependent on a host of issues. Just what standards would Congress provide in the sense that there is prefunding, what type of eligibility, benefit accrual vesting standards would be required? And it's a bit of the chicken and the egg in terms of how much leeway there should be.

I think there needs to be flexibility as to the funding decision. In other words, if funding incentives are provided, a company should have the right to decide whether it's financially feasible in their instance, and advantageous to take advantage of those funding incentives, the degree to which they do, if at all.

Chairman PICKLE. Let me ask Mr. Gold a question.

You said in your statement that with respect to credit research, the FASB report or funding these health plans would have minimum impact on the valuation of existing fixed income assets.

You also said that in the area of impact, as far as mergers and acquisitions, that providing help for retiree benefits would not have any serious impact in that area.

But you do say that in the absence of tax favored funding, the new standards are likely to accelerate benefit reductions and cost shifting to employees. You're saying that if FASB does bring this about and you have to account for these promised benefits, that that might cause a reduction in benefits and/or costs would be shifted to employees. But you don't say it should or shouldn't be done.

Do you have a position on that?

Mr. GOLD. On which issue? On whether the tax incentive should be provided?

Chairman PICKLE. Whether the tax incentive should be provided, or should we take action in this field?

If we take action and don't give taxes—I didn't ask the question with respect to what I thought it would be related to, the tax incentive, but the program as a whole.

If we do advance it, some of the companies may say it's too expensive, I'll cut it. So, the question is, should we go ahead with it or not? Should the Congress do something about it?

Mr. GOLD. On the tradeoff, between allowing funding and the cutting back by employers, is that the question? Should Congress act to influence that tradeoff?

I don't have the expertise or the sense of whether Congress should or shouldn't act on that.

I'm here to give a sense I think of how capital markets may react to accounting or to tax incentives. I think that there are some tradeoffs, and that's what I speak to.

Chairman PICKLE. All right. Thank you.

Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman.

I believe what you were alluding to was the testimony where Mr. Gold says in the absence of effective tax funding, the new standards are likely to accelerate benefit reductions and cost shifting to employees.

You are predicting behavior there aren't you, Mr. Gold? And you believe that that's a result.

Mr. GOLD. Yes. I think that some benefit reductions and some cost shifting are likely to occur. I think the identification of the liabilities makes that happen sooner rather than later. I think that if the funding were efficient, less of the shifting would occur.

Mr. CHANDLER. I believe an important point to be underscored here is Mr. Dopkeen and Ms. Chollet both testified that these are benefits that are most beneficial to lower income individuals. Don't I understand both of you to have made that statement?

Mr. DOPKEEN. That's correct.

Ms. CHOLLET. Middle income and lower income, yes.

Mr. CHANDLER. Without any rules on the part of the Government of the United States, this has occurred, that is, these middle and lower income people have benefitted almost to the same extend that any higher income people would have.

So if the behavior predicted by Mr. Gold were to actually occur, then those middle and lower income people would be significantly affected by those decisions being made by companies adjusting or terminating or shifting costs.

Ms. CHOLLET. The question arises as to the degree to which the companies could adjust costs for current retirees, retirees already in receipt of these benefits. Possibly, possibly not.

Certainly that's true for workers near retirement, for our now retiring generation of workers, yes.

It's the lower income, middle income, new retirees who will be confronting the world without assistance from a company plan.

Mr. CHANDLER. Let me just, if I may Mr. Chairman, make sure I make a point here. That is that Mr. Dankner testified, and I very much agree, that once a person is retired, there are really only three sources of funds to pay medical expenses. One is the individual, clearly. Second is the individual's previous employer. And third is the Government.

Now, we heard testimony earlier that most—in fact 98 percent—of those offering or providing retiree health benefits have not prefunded. I believe it's fair to say that individuals have not prefunded their retiree health benefits. And I believe it's also fair to say that Government hasn't prefunded its liability. Those three are all unprepared. They also face a demographic change of absolutely monumental proportions that will make the reports required by FASB today very much different by the time we reach the age of retirement for most of us in our forties and somewhat younger.

Is that a fair statement, Ms. Chollet?

Ms. CHOLLET. I think it's a fair statement, sir.

Mr. CHANDLER. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Dankner and all of the witnesses, I appreciate very much your testimony. Mr. Dankner, I wonder if you support the proposition of the testimony that we've had here today that a company's retiree health costs will be the same before and after the promised benefits are recognized in a company's financial statement?

Mr. DANKNER. Well, I think the question is how will the companies respond to a new FASB standard? I think that in our experience in working with a lot of major companies, in addition to the 25 in the field test, is that most companies are looking hard at the

retiree health programs now and just what can they do in the way of changing them, changing the word "promises" to "dollars" which is a notion that we had talked about a long time ago. It's very hard to do and easy to talk about, or adding deductibles, copays, in many ways ratcheting back the promise, to control cost.

I know of a number of major companies looking at that right now. Now, is the FASB the sole driving force? I don't think so. Certainly it is having an effect, and it has gotten the attention of senior executives in major companies to look at their programs.

Mr. FLIPPO. Are you concerned about the reasonableness of the approach described by our witnesses of FASB, the approach of using the greater of either 15 years or the average remaining service periods of employees expected to receive the benefits?

The way they're talking about phasing that in, is that a concern that you have or have looked at carefully?

Mr. DANKNER. Yes. In the field test, we are analyzing again major factors that would influence the answer. And certainly the transition period is a major component and a major issue in terms of its influence on the answer, as will be the guidance given on the health care cost trend assumption as well as the discount rate.

Mr. FLIPPO. I think everyone is really going to be interested in receiving your report. It will be very good to do that.

May I ask Ms. Chollet, I believe you testified that—or did you testify that the adoption of the catastrophic health insurance would reduce employer costs?

Ms. CHOLLET. Yes, sir. The estimates that we used to reduce our estimate of unfunded liability added up to about 30 percent.

In my testimony I list for the members of the committee the reductions that we assumed in each year during the 5-year phase-in over which the new Medicare benefits become effective.

The most important part of the reduction has to do with Medicare coverage of prescription drugs. Virtually all employer plans for which we have data available from the Bureau of Labor Statistics cover prescription drugs; that is a very expensive component of retiree health insurance plans, because of the relatively generous Medicare coverage already in place for hospital care.

The effect of the new Medicare benefits varies widely from plan to plan. In working with Milliman & Robertson, a major actuarial firm, in producing our estimate, I had the opportunity to look at estimates they had done for several plans, something on the order of 15 plans. And their estimates for the effect of the new Medicare legislation varied radically, largely having to do with the individual plan provisions and the rate at which physicians in the retiree service area have accepted assignment for physician services.

Our estimates are, to some degree, guesswork. They are simply an educated guess from looking at that range of possible estimates.

Mr. FLIPPO. Well, I hope that perhaps the study that is being conducted will give us further light on that.

May I ask Dr. Dopkeen. I believe—was it your testimony that you didn't think that tax incentives had been utilized very much by corporations in regard to this?

Mr. DOPKEEN. No. In fact, the point that I was trying to make was that the sort of development of retiree health benefits was responsible for a number of pressures, but in fact there were incen-

tives from the very beginning, the same incentives that encouraged the development of health coverage for active employees.

I think the present tax incentives throughout the 1950's and subsequently have contributed powerfully to the offering of the benefit.

Mr. FLIPPO. So you feel that that contributed to the promise. But, in your judgment, has it been an efficient method of approaching the problem? Because we've had testimony here today that suggests we need to provide some further incentives in this area. And I just wanted to see what history tells us about the utilization of the report.

Mr. DOPKEEN. Let me distinguish myself from my company as I approach that question. We don't have a policy on that.

I have thoughts about that. I believe certainly it has been efficient to the point where we have this very broad coverage that is certainly richer than what private coverage is available in the private medigap market.

It has benefitted an awful lot of people. I personally believe that, at present tax incentives it would be an efficient way to promote certainly through prefunding, to promote reserves wherever possible that would develop in time, and certainly to have reserves on hand for the baby-boom generation to be adequately funded.

I also believe that the use of tax favored prefunding might develop reserves that would attract the interest of the insurance industry in developing better long-term care and acute blended products.

Mr. FLIPPO. Thank you.

Mr. Chairman, I did want to propose one quick question to Mr. Gold.

Mr. Gold, I believe you testified that the treatment that FASB is proposing would increase the cost of equity capital.

Mr. GOLD. Yes, I did.

Mr. FLIPPO. And let me ask you then, would their proposal not encourage savings as opposed to consumption, and would you agree that it would increase savings, and does that have a factor toward decreasing the cost of capital? Have you factored that into your judgment about increasing the cost of equity capital?

Mr. GOLD. I'm not certain that it increases savings. I think that the companies invest in each other's securities. This is what happens in pension plans.

What we really do is diversify. We don't create something new there. I think it is the analysis that Wall Street performs which will shift capital between stocks and bonds on the one hand, and between domestic stocks and foreign stocks on the other, which will raise the cost of capital.

I am very concerned about some of the implications vis-a-vis international competitors. I am that way because I have heard corporate officers from the industrial sectors who are themselves concerned about that.

Mr. FLIPPO. Thank you very much for your response. And thank you, Mr. Chairman, for your patience.

Chairman PICKLE. Thank you, Mr. Flippo.

We have a vote on the floor. And I want to ask at this point, will the panelists, the ones starting with the AARP and then the other

two or three panels, will you be able to come back if we recess temporarily for the lunch period?

Is there anybody that can't do it?

[No response.]

Chairman PICKLE. All right then. I am going to say that we will recess in just a minute and resume again at 1 o'clock, or as soon thereafter as we can, if that's agreeable to everybody.

Now, I want to, before you get away from here, if I've got time, ask one last question. FASB is expected to make their report this fall.

Is there any disagreement on this panel that they should issue the report? Is retiree health a liability for accounting purposes?

They testified this morning that it was. But, how they're going to handle it or recommend it, we don't know.

Do you agree that it is an obligation or a liability and somehow it ought to be accounted for? Is there any disagreement on that?

[No response.]

Chairman PICKLE. All right. Is there any disagreement that the amount of so-called liability as it is represented is enormous, $400 billion or $1 trillion? It is somewhere in that neighborhood. Is there any general disagreement on that?

[No response.]

Chairman PICKLE. All right.

Then the committee will stand recessed until around 1 o'clock.

[Whereupon, at 12:10 p.m., the subcommittee recessed, to reconvene at 1 p.m.]

AFTERNOON SESSION

Chairman PICKLE. The subcommittee will come to order again.

Our next witness will be Mr. Jack Guildroy, who is a member of the board of directors of the American Association of Retired Persons.

Mr. Guildroy, we are sorry that we have been slow in reaching you, but we have had these interruptions.

Mr. Guildroy, we are glad to have you. If you will proceed, sir.

STATEMENT OF JACK GUILDROY, MEMBER, BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS, ACCOMPANIED BY STEPHANIE KENNAN AND DAVID CERTNER

Mr. GUILDROY. Thank you, Mr. Chairman. My name is Jack Guildroy. I am on the board of directors of the American Association of Retired Persons. And with me are two members of our legislative staff, Stephanie Kennan and David Certner.

AARP is pleased to appear before this subcommittee to testify on the important issue of employer-sponsored postretirement health benefits.

PHRBs are becoming increasingly important for adequate and affordable health coverage of older Americans. Why are they so important?

First, with the explosive growth in medical care costs, it is increasingly difficult for older Americans to finance their health care expenditures.

Second, postretirement medical coverage may not be available when most needed because the retiree is uninsurable.

And, third, the financial consequences of an uninsured individual fall heavily on the individual and society.

The Federal Government should continue to strengthen health care programs, including long-term care. But the private sector must also continue to play an important role.

Among those receiving PRHB's, there are subgroups that deserve special attention. Early retirees under the age of 65, not yet eligible for Medicare, are especially vulnerable. Many in this group retire early with the expectation that health care insurance will be provided. Without such group insurance, individual insurance is very expensive, assuming it's obtainable at all. Employers should be encouraged to take more responsibility for this group.

A second vulnerable group are those too poor to pay Medicare cost-sharing requirements and who are eligible for Medicaid. Although the recently enacted catastrophic health care legislation will reach some of these individuals, we must continue to be concerned with access to care for the poor and near poor retiree. And even though the catastrophic health care legislation provides significant protections for Medicare retirees, medical inflation continues to take its toll on the out-of-pocket costs of the elderly. Indeed, Medicare beneficiaries are still paying the same percentage of income for health services as they did before the enactment of Medicare.

Also, all retirees are vulnerable to the costs of long-term care, which are rarely covered by any insurance. Despite the gaps in health coverage for retired Americans, a number of factors raise questions about the future of PRHB's.

Employers are now counseled to more clearly reserve the right to cancel PRHB's. FASB's expected ruling requiring greater accounting for PRHB's could prove to be the major catalyst for PRHB changes.

The new FASB requirement will cause many employers to reduce benefits since employers must either advance fund PRHBs or carry a significant balance sheet liability. Recent tax legislation, however, has severely limited the ability of employers to prefund benefits.

A balance must be reached between employer commitment and benefit adequacy. One disturbing trend is the shift by employers to cash benefits, which obviously cannot keep pace with health care inflation, and will cause retirees to fall further behind in planning and financing health care needs.

A second problem for retirees is the lack of an enforceable promise. Some form of prefunding should be encouraged to ensure that the money is there when the retiree needs it. Also there is a strong need for some form of vesting of the PRHB right. There is no guarantee of receiving benefits unless a standard is established by which the employee may earn the benefit.

In order to further secure PRHB's, employers should be encouraged by the Government to finance the promise. Of course, any tax incentive will have a cost to the Treasury, and this must be carefully balanced and properly allocated.

PRHB's serve an important segment of the American population. We should not simply allow employers to pull the plug on these benefits. Employer incentives with appropriate standards are therefore necessary to ensure the continued availability of PRHB's.

Mr. Chairman, our association looks forward to working with your committee in efforts to preserve and expand the value of PRHB's.

Thank you very much.

[The statement of Mr. Guildroy follows:]

STATEMENT OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) is pleased to appear before the House Ways and Means Oversight Subcommittee to testify on the important issue of employer-sponsored post-retirement health benefits.

I. Overview.

Post-retirement health benefits (PRHB's), which cover about one-fourth of all those over age 65, and carry a price tag estimated at between $100 billion and $2 trillion for the companies that sponsor them, are becoming increasingly important to the retirement security of older Americans. In the face of mounting, unfunded liabilities, many companies are restricting these plans which help safeguard retiring workers from overwhelming medical care costs at a time of life when medical attention may be most needed.

PRHB's fulfill a much needed role in the retiree health framework, and AARP encourages their creation and sustenance. However, it is also clear that a number of current practices and problems obviate the full effectiveness of this benefit system, and, in fact, call into question the survivability of PRHB's for future retirees.

The growing financial liabilities of companies who do not prefund these plans; anticipated additional financial pressure, in the wake of new accounting procedures expected to be imposed by the Financial Accounting Standards Board (FASB); the increasing number of elderly retirees, including early retirees, who expect to receive promised PHRB's; and the rapidly rising costs of health care; these are a few of the factors which raise questions about the future of PRHB's.

In order to encourage these much needed benefits, better incentives are necessary to induce companies to continue, or begin sponsoring, PRHB's. In addition, incentives to companies to pre-fund their plans would help assure the availability of funds to meet the health care expenses of retiring workers who plan on using the benefits they were promised earlier.

The Association supports the continued growth and health of employer-sponsored PRHB's. Otherwise, should employers abandon PRHB's, an important thread in the medical security blanket which covers so many older Americans will be lost, leaving many older Americans more vulnerable to rising health costs without adequate protection.

II. Post-Retirement Health Benefits -- Description.

Post-retirement health benefits are health care benefits provided by an employer to retirees through the employer's group health plan. The benefits partially or fully cover costs that are not paid by Medicare. The cost of providing the coverage is usually included in general retirement welfare benefits, designed to complement private pension coverage to ensure a total retirement income package. PRHB's are almost always in the form of actual health services, as opposed to cash outlays, and are generally available to the retiree's spouse and dependents.

PRHB's are usually similar to the hospital and medical coverage provided to active employees. For retirees under 65, coverage is normally identical to that provided to active workers. For those retirees over 65 and eligible for Medicare, PRHB's generally complement Medicare to provide additional coverage.

PRHB's most often apply to employees who have become eligible (vested) for retirement plan benefits, if offered by the company, and who have retired from the company. Long term employees who voluntarily leave or are terminated prior to retirement do not generally receive these medical benefits even if they are vested in the pension plan. PRHB entitlement also commonly follows eligibility for early retirement, which generally entails 10 to 15 years of service to the company as well as attainment of the 55th or 60th birthday.

III. Coverage.

According to a recent Department of Labor study, nearly 6.9 million retirees or their dependents were under the umbrella of employer provided health insurance. Approximately one-third of this total number of retirees were early retirees under the age of 65. Similarly, one of every six retirees over the age of 65 was covered by an employer provided post-retirement health plan. Typically, PRHB's are most often offered in larger, older "smokestack" industries, which tend to be heavily unionized.

Approximately ninety-five percent of the largest corporations and 86 percent of those with more than 1,000 employees provide these benefits. Many smaller and medium-sized firms also provide retiring workers with this coverage. At least 16 percent of the current workforce may currently receive post-retirement health benefits. However, closer to twice that amount may be working at firms where they may eventually become eligible for this benefit.

IV. Importance of Retiree Health Benefits.

Adequate and affordable health coverage is one of the great needs of older Americans, and one disparate of other types of expenses. The federal government should continue to strengthen health care coverage, including long-term care. The private sector, however, must continue to play an important role. A number of factors call for the continuation of PRHB's:

- o Post-retirement medical coverage may not be available when most needed because the retiree is uninsurable,
- o The financial consequences of an uninsured individual fall heavily on the individual and society, and
- o The additional security provided by PRHB's benefits us all as the population of elderly Americans grows larger, particularly as a result of longer life expectancy.

A. Protecting the Vulnerable Elderly.

Among those receiving PRHB's, there are subgroups that deserve heightened attention. Early retirees under the age of 65 are especially vulnerable because there are few alternatives for them except employer provided health benefits. Many in this group retire early with the expectation--indeed, often the promise-- that health care insurance will be provided. If that group insurance is cancelled, insurance on an individual basis, assuming health insurance is even obtainable, is very expensive and usually provides reduced coverage.

Employers should be encouraged to take more responsibility for those not yet eligible for Medicare. For example, the Committee should examine employer continuation of health coverage, as embodied in similar COBRA legislation, for the under 65 age group. The Department of Labor has estimated that one-third of retirees with post-retiree health benefits retired early. Studies have estimated the cost of insuring these younger retirees at between $2,000 - $5,000 a year, roughly about four times the amount for Medicare-eligible retirees.

Second, while catastrophic health care legislation reaches a segment of the vulnerable elderly who are too poor to pay Medicare cost-sharing requirements and who are eligible for Medicaid, we must continue to be concerned with access to care for the poor and near-poor retiree.

B. Out-of-pocket costs.

For retirees, even those with Medicare and other coverage, health care costs are a growing fear. While the passage of the Medicare Catastrophic Coverage Act of 1988 provides significant protections for retirees eligible for Medicare, medical inflation continues to take its toll on the out-of-pocket costs of the elderly.

Medical inflation has been running many more times the rate of general inflation. Regardless of the type of health coverage an individual may have, when retirees become ill they have little control over health care providers' price of services, or ability to question the necessity of tests and services recommended by a physician.

In addition, the elderly face the costs of long-term care. Medicare and private insurers combined pay only a miniscule portion of nursing home costs -- less than three percent in 1986. More than half of nursing home costs are paid out of the pockets of residents and their families. We also know that the elderly are risk adverse, frequently insuring themselves with multiple medigap insurance policies. However, these policies do not cover the needs of long-term care.

Even retirees eligible for Medicare face significant cost-sharing requirements. For example, the annual "$75" deductible really represents approximately $100 - $125 in true out-of-pocket costs before Medicare Part B begins to cover services. This is because Medicare employs the concept of "reasonable charge," which is frequently less than the actual charge for physician services, to measure expenditures toward the deductible.

Second, beneficiaries are responsible for coinsurance of 20 percent for physician services whether or not the physician accepts Medicare reasonable charge determination as payment in full. In the past 7 years, the amount of coinsurance beneficiaries have had to pay has increased from slightly over $2 billion to over $6 billion. This is in large part due to the increase in volume of services provided to beneficiaries, a factor over which the patient has little control. We must become more sophisticated in our determination of appropriate and necessary care without creating barriers to that needed care.

Beneficiaries are also responsible for premiums for Part B services. These premiums by law must equal 25 percent of program costs. With little success in controlling Part B costs to date, these premiums have climbed over 150 percent since 1980.

In addition, retirees are responsible for noncovered services. According to AARP estimates, prior to the expansions provided by the catastrophic health care legislation, on average, for every $1.00 beneficiaries incurred in coinsurance and deductibles, they spent an additional $.50 to $1.00 for noncovered services and goods. Indeed, Medicare beneficiaries are still paying the same percentage of income for health services as they did prior to the enactment of Medicare.

C. The Impact of the Catastrophic Health Care Act of 1988.

With the provision of additional benefits under Medicare, such as the prescription drug benefit and the cap on Part B

expenses, and the one-time hospital deductible per year, employers should eventually see a diminished role in providing acute care benefits for the over 65 retiree. Employers who provide retired workers with Medigap health care benefits which duplicate the new Medicare benefits will be required to provide retirees with either additional benefits or a cash refund equal to the insurance value of the benefits. AARP hopes this "maintenance of effort" provision will lead to more expanded coverage of services not currently provided.

V. PRHB Cost to Employer.

Initially, employers thought that the cost of PRHB's would be minimal. However, the past 20 years have seen a steady rise in the PRHB price tag as well as in the value of the benefits. The Department of Labor estimated the direct costs of employer-provided PRHB's at about $4.6 billion calculated on a pay-as-you-go basis for 1985. Estimates on the accrued liability for these benefits range from a conservative $100 billion to as high as $2 trillion. In some cases, accrued liabilities for PRHB's may exceed a company's net worth.

Several factors help to account for the rising costs of PRHB's. One of the factors raising the cost of PRHB's is that retirees are living longer. Extended life expectancies naturally increase the cost of providing retiree benefits for a longer period of time. Not only are retirees living longer, but the number of retirees compared to active workers has increased. The increased costs of a larger pool of retirees are exacerbated by the decrease in the number of active workers who help fund the benefit.

Adding to the growth in the number of retirees is the trend towards early retirement. The high cost of PRHB's for this group is due not only to the length of coverage, but also because Medicare does not supplement coverage for those under 65 (except for those deemed disabled under Medicare provision.)

Another trend affecting the cost of PRHB's is the shifting of responsibility for health care from the public to the private sector. The increased cost sharing for Medicare participants through copayments, deductibles, and increased premiums has placed additional cost burdens on PRHB's.

The overall rise in health care costs is also an important factor in explaining the increased costliness of PRHB's. In the past two decades, from 1965 to 1985, the amount spent on health care has skyrocketed nearly 10 times from just over $40 billion to nearly $400 billion. Since 1967, the medical care inflation rate has been more than 300 percent, as compared to the general inflation rate of 222 percent. Last year, in 1987, the rate of inflation in the medical care component of the consumer price index was more than one and a half times the rate of inflation in the general economy.

All these factors explain the rapidly increasing cost of PRHB's, which have dramatically altered the willingness of many employers to commit to retirement health benefits for their employees. In the eyes of many employers, these benefits have mushroomed into a huge unforeseen corporate liability.

VI. Current Status of PRHB's.

At present, there are no statutory mandates governing "participation," "vesting," or "funding" of PRHB's. Unlike pension benefits, which are strictly governed by ERISA, retiree health benefits do not have the statutory mandate to protect employees from employer changes. Consequently, the question of whether or not employers may modify or terminate PRHB's has fallen to the courts.

In order to safeguard their promised benefits, retirees have

filed suit under ERISA and the Labor Management Relations Act (LMRA). When ERISA was enacted in 1974, it established minimum standards for vesting, participation, accrual of rights, funding and terminations of pensions, but not for health benefits such as PRHB's. Until recently, employers showed little or no concern with modifying PRHB's. However, business reorganizations and resulting legal challenges have necessitated a closer look at the employer's commitment to providing health and welfare benefits to retirees.

Retirees generally look for relief based on the promise of lifetime benefits under a labor contract or based on an employer's representations regarding future benefit rights. In the majority of instances, the cases have turned on the intent of the parties, based on the particular facts and circumstances of each case. The courts consider the intent of the collective bargaining agreement and/or what the retirees could reasonably have expected in light of the employer's explanations and declarations of what was promised at retirement.

The courts have defined the basic issue as whether employers have made a promise to maintain benefits or whether retirees could reasonably believe they were promised lifelong benefits. According to basic principles of contract law, if the plan intended to provide lifetime health benefits to retirees, then the benefits cannot be reduced.

Although the jury is still out on this issue, a majority of courts have found that "contractual vesting" had occurred at retirement absent clear and unambiguous language that the employer did not intend to provide lifetime coverage or that the employer reserved the right to modify or terminate the benefits. Similar approaches have been taken in both collectively bargained and non-collectively bargained plans.

While many courts have thus far looked favorably on retirees' claims, such protection may not be available for future retirees. Increasingly, employers are counseled to more clearly reserve the right to cancel or modify PRHB's.

VII. Rulings and Legislation Relating to PRHB's.

The imminent FASB ruling, expected later this fall, could prove to be the major catalyst for PHRB changes. While intended to ensure that companies account for promised benefits, AARP is concerned that the ruling might be a deterrent to many companies to establish or maintain the benefits. On the other hand, requiring accounting for PRHB's on an accrual basis, as FASB is considering, would ensure that employers look more clearly at, and take more responsibility for, their future PRHB liability.

Only a very small percentage of employers currently pre-fund retiree health benefits. The expected FASB ruling, although modified to include a minimum liability only for current retirees, will require employers to either advance fund these benefits or carry a significant liability on the balance sheet. Thus, FASB may cause many employers to cut back on benefits, and provide a strong impetus for some employers to pre-fund.

However, recent tax legislation has curtailed the ability to prefund. The 1984 Deficit Reduction Act (DEFRA), which grew out of revenue-raising pressures to halt abuses of some funded welfare plans as tax shelters, hit hard at the ability of employers to fund PRHB's on a tax-favored basis. The voluntary employees' beneficiary association (VEBA), a traditional vehicle for pre-funding PRHB's, has thus been severely limited by DEFRA. This legislation reduced the amount of reserves that could be set aside for future PRHB's. In addition, these funds can no longer accumulate on a tax free basis.

Given FASB's increased focus on PRHB's, their survivability is certainly called into question. In light of the reduced incentives for companies to sponsor these benefits, AARP fears that millions of elderly Americans may never receive the benefits that are often crucial to meeting their mounting health costs.

Companies who do not pre-fund these plans may not be able to meet their obligations to retirees who rely on this benefit. Moreover, future retirees may never benefit from these plans if companies discontinue their sponsorship due to fear of excess financial liability, particularly in the absence of any tax privileges to facilitate pre-funding. Too many elderly Americans are finding that promises of PRHB's were empty promises. AARP believes that the promises made to individuals years ago -- promises that have been relied upon -- ought to be honored, especially at their greatest time of need.

VIII. Action Needed.

The basic issues may be simply stated. On the employer's side, there is the need for a definable obligation. A balance must be reached regarding employer commitment and benefit adequacy. What is considered an "adequate" benefit is currently under debate, particularly as a result of economic and demographic changes.

As a consequence of these changes, new benefit trends are emerging. One such trend, largely the result of less predictable costs, is the shift by employers towards defined contribution promises -- which are promises to provide an employee with a certain amount of cash to purchase health care -- and away from defined benefit promises -- which guarantee a certain level of health care services.

This is a disturbing trend because the retiree is not as well protected under a defined contribution plan. First, the cash payment at retirement is considered taxable income. But of more crucial concern, the cash contribution generally will not keep pace with health care inflation, and the retiree will fall further behind in his ability to plan for and finance his health care needs.

The employee is also unable to adequately plan for retirement unless there is an enforceable guaranteed promise. Some form of pre-funding should be encouraged for PRHB's to ensure that money is there when the retiree needs it. Otherwise, the promise carries little weight. However, in addition to pre-funding, there is a strong need for some form of "vesting" of the PRHB right. While there may be a promise of benefits, as well as the money to finance them, there is no guarantee of receiving PRHB's unless a standard is established by which the employee may earn the right to receive the benefit.

In order to further safeguard PRHB's, employers should be encouraged by the government to finance the promise. Even when the earlier concerns are addressed, the future of PRHB's will not be encouraging until there is an adequate means of paying for the liabilities. Funding the full health benefit provides the best protection for retirees and lowest risk of pay-as-you-go costs to the employer.

Of course, encouraging pre-funding will have a cost to the Treasury. To the extent that PRHB's benefit those who already have better retirement income packages, tax benefits for PRHB's should be balanced with improvements in public health programs. In addition, tax advantages for PRHB's necessitate that appropriate standards for funding, vesting, and participation be enacted in order to ensure proper allocation of the tax benefit. If tax funds are used to pay a portion of the benefits, we must ensure these benefits are distributed fairly. These rules may

or may not prove successful in encouraging the growth of PRHB's.

IX. Conclusion.

PRHB's serve an important and useful purpose for a significant segment of the American population. In light of this, we should not allow employers to pull the plug on these benefits altogether. With the explosive growth in medical costs, it is increasingly difficult for older Americans to personally finance the portion of their health care tab that Medicare will not pick up.

Many employers recognize a social obligation to offer protection to their retiring workers through PRHB's. However, as the FASB will in part soon require, they must do more than offer unsubstantiated promises to address this need. Employer incentives, and appropriate standards, are therefore necessary to ensure the continued survivability of PRHB's, a valuable component in the retirement income framework. Otherwise, millions of Americans could continue to suffer the consequences of a health need unmet, and a promise unkept.

The Association looks forward to continued work with this committee on the issues of employer-provided health benefits, and health policy in general. Ongoing discussions should lead to action that will create a more secure retirement for older Americans.

Chairman PICKLE. Thank you, Mr. Guildroy.

Do you recommend any of the bills that have been introduced or have been advanced thus far? Do you have a specific measure that you are supporting?

Mr. GUILDROY. No, we do not.

Chairman PICKLE. And other than the cautions and the recommendations of your testimony, you are just willing for us to proceed, hoping that we do pass a measure of some kind that will protect these health benefits?

Mr. GUILDROY. That is correct.

Chairman PICKLE. Now, I notice that you said that one caution was that you ought to have kind of a clause in your contract; that is the employer's statement to the right of employees that they can modify the contract.

Now, you also stated that there should be a balance needed. By that I assume you're saying that they should have the right to modify but not cancel it outright.

How would you maintain that balance? How would you go about that?

Mr. GUILDROY. Our basic position, Mr. Chairman, is that once a worker has a clear understanding of what the health benefits are going to be, there should be no change in that. If one gets to——

Chairman PICKLE. Now you're talking about under the present operation now, once a company offers an employee certain basic health retiree benefits, that that ought to stay put in place.

Mr. GUILDROY. That's correct. There should be some guarantee.

Chairman PICKLE. Do you know what kind of guarantee, is what I am trying to find out?

Mr. GUILDROY. Well, I think that we can probably look to the pension system in the pension legislation as a model for what ought to be done.

We are fairly satisfied with the pension arrangements that have been set up by ERISA, and which have been improved recently by Congress. We think perhaps that should be looked at as a possible model for health care benefits, including such things as who can participate, what the vesting standards ought to be, what rights an employee—as well as an employer—should have, what the funding mechanism should be, those types of issues.

Chairman PICKLE. Your statement is that once an agreement is reached, the employee ought to be protected, although there would be some right given to the employer, his rights ought to be protected.

I assume you mean by that, that once a general agreement or contact has been made, whether it's written or verbal, it is an obligation of the company?

Mr. GUILDROY. That's correct.

Chairman PICKLE. And I assume you then would recommend that FASB make their report as quickly as possible and that they would consider these promises or these general agreements as a liability of the company to carry forth.

Mr. GUILDROY. Well, the way I would approach the answer to your question about FASB would be that if it is considered, as I think it is, the authority on proper accounting procedures, surely

everyone would like to know what those proper accounting procedures are from that point of view.

So, surely we would encourage the organization that has been given that responsibility to come forth with its recommendations or its statement as soon as possible.

Chairman PICKLE. GAO had testified that the liability of these funds are as much as $402 billion.

Is that a figure your organization is in general agreement with?

Mr. GUILDROY. We have no specific figure. I know that the estimated figure varies between, what is it, $100 billion and $2 trillion. And perhaps hearing the figure $400 billion is a relief to some folks who have thought about $2 trillion.

We don't have any fix on that figure, Mr. Chairman.

Chairman PICKLE. Well, on page 15 of your written testimony, you said that by encouraging companies to prefund their retiree health plans, that it would have a cost to the Treasury.

Mr. GUILDROY. Yes.

Chairman PICKLE. And you go on to say that, to the extent that the prepaid retirement health benefits benefit those who already have retirement income packages, tax benefits for those programs should be balanced with improvement in public health programs.

My question is how does increased spending for public health programs balance the loss to the Treasury that would result from encouraging this prefunding?

Mr. GUILDROY. Are you asking about the value of the tax expenditures involved too?

Chairman PICKLE. I'm talking about how it would be, if we had this development, how would that be a loss to the Treasury?

Mr. GUILDROY. I think that what we're suggesting is that part of the 1984 DEFRA legislation be reexamined to permit some set-asides for these benefits with the tax advantages that companies enjoyed before the passage of that Act.

But, in order to do that, there ought to also be some mechanism set up to ensure that those tax expenditures or tax incentives are used wisely so that employers do not abuse the system.

My understanding is that there were some abuses of the system, and that was the reason not only for some of the revenue loss, but that abuse of the system also caused the inclusion of that part of the DEFRA legislation.

Chairman PICKLE. Well, along that same line, let me ask you a question that would shed some light on this.

Should we offset the revenue loss that would result from the prefunding of retiree health plans by reducing the tax incentives currently given to pension plans?

Mr. GUILDROY. I don't think we ought to tamper with the pension plan as such. There is, for example, a proposal to take some of the so-called excess assets of pension plans and put them into the health benefit programs. We have a great deal of problem with that because assets in the pension program, as such, should be left there—just as we feel that reversion of excess pension assets should not take place, we also do not think that there should be set-asides for health benefit programs out of pension money.

We feel that those revenues have been earmarked for the pension program and should remain so. And we don't know, for exam-

ple, how often in the future we are going to have repetitions of something like the stock market crash of 1987.

Chairman PICKLE. Well, I don't think the Congress is going to be reducing the pension payment level in any way. I just wondered if you were going to recommend that. But you do not recommend that?

Mr. GUILDROY. No, we do not.

Chairman PICKLE. Now, you said also in your statement that you were somewhat disturbed about the shift in these prepaid programs on the defined benefit plan to a contribution plan.

Mr. GUILDROY. To a cash program.

Chairman PICKLE. Yes. Now, how could the Congress or this committee, how could we encourage companies to make defined contribution promises which guarantee a certain level of health care? How can we in Congress do that? How would we go about doing that?

Mr. GUILDROY. I think perhaps one of the major points that hasn't been stressed in our colloquy, Mr. Chairman, is addressing the overall cost of health care in this country.

I think, if we in this Nation were able to do something about controlling the cost of health care, then this might have some effect not only on employers but on other segments of society that provide health benefits, like the Government, for example, in the case of Medicare.

I heard just today that part of our health costs for this year, a very important part, namely Part B of Medicare, has suffered through inflation to the extent of something like 14-percent. And that may be a little better than the previous year.

On the other hand, when one compares the 14-percent inflation in this important segment of health care as against the general inflation of something like 4 or 4½ percent, I have to be appalled, continue to be appalled at what is happening to health care throughout our system, not just in Medicare, but throughout our medical and health care system.

If we can do something about controlling costs of health care, possibly employers will be encouraged, possibly that will be an incentive to set aside programs like this extremely important one because the costs will not be so much.

Chairman PICKLE. Well, let me try once more with you by way of summary.

My question to you was, you were disturbed about the shift from defined benefit to defined contribution plans.

Mr. GUILDROY. That's correct.

Chairman PICKLE. And I asked you how could we, the Congress, control that? And you said by controlling the cost of health care. Is that your answer?

Mr. GUILDROY. That is one of the basic ways of encouraging employers to continue the present system, those of them that have the defined benefits plan. Yes, I think that controlling costs will be a signal to employers and others to maintain health benefits.

Chairman PICKLE. All right.

Mr. Chandler, do you have any questions?

Mr. CHANDLER. Well, just briefly. I believe your questions elicited responses which I would have sought.

In your testimony, you talk about the current retirees and the importance of the employer-provided retiree medical.

Thinking of those people who are working today, do you view the prefunding of a retiree health benefit as a savings or deferred compensation?

Mr. GUILDROY. Yes.

Mr. CHANDLER. A savings versus——

Mr. GUILDROY. Not a severance pay, but as deferred compensation, yes.

Mr. CHANDLER. In your mind and that of the organization, is that a laudable goal and method that we ought to be utilizing?

Mr. GUILDROY. Yes.

Mr. CHANDLER. For future retirees.

In your mind, in 20 years, how will this problem be different than it is today? What will your membership be telling you then if we don't change anything in terms of current law for prefunding, setting aside assets for Medicare and Social Security? How do you think the demographic changes are going to change the problems?

Mr. GUILDROY. Well, I think the problem will be even worse than it is today. No question about it. Because there will be more retirees. Persons will be living much longer. Persons will live to be older and frailer than the present population. Health needs will be much greater. Technology will be more expensive. And without these benefits, our problems as a Nation are going to be even more severe than they are at the present time.

Mr. CHANDLER. I think that's a good answer. Mr. Chairman, I thank you.

Chairman PICKLE. Mr. Guildroy, I want to depart a little bit from the hearing. You are here, and we don't always have an AARP person in front of us.

I want to ask you a question about UBIT and the program that you carry on.

I read a recent article about this in Business Week, I think it was, or some national publication.

Can you tell me how much your organization receives annually as royalty income from your sale of health insurance to your members? Can you tell me?

Mr. GUILDROY. Mr. Chairman, I don't have that figure. That figure——

Chairman PICKLE. Well, give me a good round figure.

Mr. GUILDROY. I think it's reflected in our balance sheet, which is published in the news bulletin of AARP. I think the latest one came out in June of this year.

Chairman PICKLE. Well, what did the figure show in June of this year?

Mr. GUILDROY. I'm sorry. I don't have that. May I ask one of my colleagues if he or she knows the answer?

Chairman PICKLE. Yes, you may. And while you're asking them, ask them if they pay UBIT on that income, on that royalty.

Mr. GUILDROY. Mr. Chairman, we can get that information to you almost directly.

Mr. GUILDROY. You are a representative of AARP and have no idea how much income you received on the royalties?

Mr. GUILDROY. I do not have that figure, no.

Chairman PICKLE. Well, furnish that, would you. I would like to know that.

Do you know whether you're paying UBIT on those royalties? Unrelated business income tax.

Mr. GUILDROY. I do not have that information at this time.

Chairman PICKLE. Well, do your two stalwart companions back there, do you know?

Mr. GUILDROY. No.

Chairman PICKLE. Ask them if they know what I mean by UBIT? [Laughter.]

Mr. GUILDROY. We understand the situation.

Chairman PICKLE. Well, are you paying any income on health insurance or endorsement advertisement or travel, tours? You don't know? None of you know?

While I'm asking those specific questions, ask AARP to give me a statement on it. We have not had any testimony from this great organization of yours, and we would like to know your position on UBIT. So you carry that back to your organization, will you?

Mr. GUILDROY. I think there was some full testimony on these issues less than 2 years ago by AARP. But we will be very glad to furnish that information.

Chairman PICKLE. Well, we may have that in the files. And if it is so, then we wouldn't want you to repeat.

But, as I recall it, AARP has found it rather inconvenient to testify with respect to UBIT. We would like to know what your position is.

Mr. GUILDROY. OK.

[The information of AARP follows:]

AARP

October 4, 1988

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
242 Cannon House Office Bldg.
Washington, D.C. 20515

Dear Chairman Pickle:

This letter is in response to questions you asked on September 15, 1988 of AARP Board Member Jack Guildroy, at a Subcommitee hearing on Employer Sponsored Retiree Health Insurance. Your questions concerned the unrelated business income tax. We request that this letter and attachments be included in the record of the hearing at the appropriate place.

I must say I was surprised and concerned by your statement that you did not have any testimony from AARP regarding the unrelated business income tax. In fact, AARP did testify on this subject before the Subcommitee on June 29, 1987. Written testimony begins on page 1623 of Part 2 of the record of the hearings (Serial 100-27). The oral testimony presented by Cyril F. Brickfield, then AARP's Executive Director, begins on page 1620. A copy of the oral and written testimony, which is enclosed, contains the answers to the questions you raised with Mr. Guildroy.

As part of the record for the June 29, 1987 hearing, AARP provided the Subcommittee with a copy of its 1986 financial statement, which it makes available to its entire membership by publishing it in the AARP News Bulletin. A copy of the 1987 AARP financial statement, which was distributed to the membership in the June 1988 AARP News Bulletin, is enclosed.

The 1987 financial statement shows the administrative allowance received by AARP from its group health insurance program, as well as income received from other programs and services, most of which comes in the form of royalties. The testimony to the Subcommittee lists the services that yield royalty income to AARP, and it describes why current law permits the royalty income and administrative allowance to be tax-free to AARP. This testimony also describes the tax treatment of AARP's advertising income. Furthermore, it explains that AARP expects to pay tax on income derived from the activities of its subsidiary, AARP Financial Services Corp.

Finally, you will note that the testimony describes many of the educational and community service programs of AARP.

I hope that your comments do not indicate you perceive a lack of cooperation on our part. As we have stated before, AARP remains willing to provide the Subcommittee with any assistance it may desire on the subject of tax treatment of non-profit organizations. Any additional questions that you or your staff may have can be addressed to me or to AARP's Legal Counsel, Steven Zaleznick at 728-4228.

Sincerely,

Horace B. Deets

Horace B. Deets

Attachments

AMERICAN ASSOCIATION OF RETIRED PERSONS

BALANCE SHEET

	December 31	
	1987	1986
ASSETS		
Cash	$ 4,727,000	$ 3,860,000
Treasury bills	63,708,000	26,289,000
Short-term investments committed to unearned membership dues	87,154,000	73,191,000
Accounts receivable	16,503,000	13,914,000
Prepaid expenses	10,115,000	8,125,000
Notes receivable	1,496,000	1,893,000
Investment in subsidiary	1,554,000	1,356,000
Property, furniture and equipment less accumulated depreciation and amortization of $7,714,000 and $4,440,00	13,483,000	13,781,000
Total assets before government grant assets and liabilities	198,740,000	142,409,000
Cash restricted and accounts receivable for government grant commitments	2,531,000	3,750,000
Government grant commitments	(2,531,000)	(3,750,000)
Total assets	$198,740,000	$142,409,000
LIABILITIES AND FUND BALANCES		
Liabilities:		
Unearned membership dues	$ 87,154,000	$ 73,191,000
Accounts payable	21,444,000	19,717,000
Accrued expenses	4,660,000	3,249,000
Accrued post-retirement benefits	9,825,000	3,000,000
Total liabilities	123,083,000	99,157,000
Fund balances:		
Designated by Board of Directors	17,500,000	
Undesignated	58,157,000	43,252,000
Total fund balances	75,657,000	43,252,000
Total liabilities and fund balances	$198,740,000	$142,409,000

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND BALANCES

	Year ended December 31	
	1987	1986
Operating revenues:		
Membership dues	$ 81,347,000	$ 66,796,000
Group insurance administrative allowances	67,191,000	51,624,000
Publication advertising	34,110,000	27,711,000
Income from other programs and services	29,827,000	22,382,000
Interest income	23,156,000	19,236,000
Other income	244,000	603,000
Total operating revenues	235,875,000	188,352,000
Operating expenses:		
Publications	70,438,000	62,614,000
Programs and field services	40,282,000	36,395,000
Legislation, research and development	9,799,000	8,849,000
Member services and acquisition	55,602,000	52,059,000
Activities and facilities administration	16,537,000	13,957,000
Headquarters operation	10,802,000	9,410,000
Total operating expenses	203,470,000	183,284,000
Excess of operating revenues over operating expenses	32,405,000	5,068,000
Government grant revenues	47,553,000	46,970,000
Government grant expenses	(47,553,000)	(46,970,000)
Excess of revenues over expenses	32,405,000	5,068,000
Amount designated by Board of Directors	(17,500,000)	
Amount added to undesignated funds	14,905,000	5,068,000
Undesignated fund balance, beginning of year	43,252,000	38,184,000
Undesignated fund balance, end of year	$ 58,157,000	$ 43,252,000

STATEMENT OF CHANGES IN CASH

	Year ended December 31	
	1987	1986
Cash at beginning of year	$ 3,860,000	$ 1,290,000
Additions (deductions):		
From operations—		
Excess of revenues over expenses	32,405,000	5,068,000
Add non-cash charges to operations—		
Depreciation and amortization	3,286,000	2,677,000
Increase in unearned membership dues	13,963,000	10,498,000
Equity in (earnings) and losses of subsidiary and other gains	(198,000)	229,000
Proceeds from the sale of land and building	-	1,255,000
Increase in prepaid expenses	(1,990,000)	(3,296,000)
Decrease (increase) in notes receivable	397,000	(1,194,000)
Increase in accounts payable and accrued expenses	9,963,000	84,000
Increase in accounts receivable	(2,589,000)	(2,667,000)
Total from operations	55,237,000	12,654,000
(Increase) decrease in treasury bills	(37,419,000)	2,977,000
Increase in property, furniture and equipment	(2,988,000)	(2,563,000)
Increase in short-term investments committed to unearned membership dues	(13,963,000)	(10,498,000)
Increase in cash	867,000	2,570,000
Cash at end of year	$ 4,727,000	$ 3,860,000

NOTES TO FINANCIAL STATEMENTS

Description of Organization: The American Association of Retired Persons (AARP) was organized in 1958 as a nonprofit corporation for the purpose of promoting the interests of older persons. AARP has qualified as a tax-exempt organization under Section 501(c)(4) of the Internal Revenue Code. AARP-sponsored programs include educational, research and social welfare activities with regard to older persons. AARP also publishes bimonthly magazines and monthly news bulletins which are distributed to its members.

Significant Accounting Policies: AARP prepares its financial statements on the accrual basis of accounting. The financial statements of AARP include the AARP Administrative Fund but do not include the accounts of the approximately 3,600 chapters of AARP that are organized and operate as separate entities.

AARP and its members benefit from the efforts of many volunteers. It is not practical to quantify the value of these services, and therefore, no amount is shown in the financial statements for the value of their services. Travel and subsistence costs incurred by numerous volunteers in carrying out their duties are reimbursed by AARP.

Members are given the option of paying for one-year, three-year, ten-year or lifetime memberships. The portion of membership dues applicable to publications is deferred until the related cost is incurred for those members whose dues are paid in advance.

Property, furniture, leasehold improvements and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets which range from three to ten years. Maintenance and repair costs are expensed as incurred, while renewals and betterments are capitalized.

AARP summarizes the costs of providing its various programs and other activities on a functional basis in the statement of revenues, expenses and changes in fund balances. Accordingly, certain costs are allocated among the programs and supporting services which are benefited.

The resources of AARP are included in a single fund for accounting purposes. The fund consists of undesignated fund balances and fund balances designated by the Board of Directors. The undesignated fund consists of unrestricted amounts expendable for the annual maintenance, preservation and administration of the Association. Designated funds are amounts which may be expended only for programs or purposes designated by the Board of Directors. Certain amounts in the prior year financial statements have been reclassified to conform to current year presentation.

AARP Financial Services Corporation: AARP Financial Services Corporation, a wholly owned subsidiary of AARP, is accounted for on the equity basis. AARP Financial Services Corporaton and Scudder Stevens and Clark are partners in AARP/Scudder Financial Management Company, the investment advisor to the AARP Investment Program from Scudder.

Government Grants: AARP administers government grants. Under the major grant, which has as its purpose the placement of older persons in unsubsidized employment, approximately 8,500 persons are currently enrolled at 108 sites in 33 states and Puerto Rico. This grant has been renewed annually since 1969; the primary commitment expires in June 1988; and future funding through 1989 is expected at about the current level.

Government grant revenue is recognized to the extent of grant expenses. Amounts recorded as grants receivable are for grant expenses incurred in advance of the receipt of grant funds. Funds received in advance of grant expenses are recorded as deferred income, and separate restricted bank accounts are maintained in connection therewith.

AARP Insurance Plan: The AARP Insurance Plan (the Plan) was established by an Agreement and Declaration of Trust for the purpose of providing group health insurance to AARP members. The Plan is administered by Trustees consisting of members of AARP appointed by the Board of Directors of AARP.

Group health insurance is provided under an agreement with Prudential Insurance Company of America (Prudential). AARP receives administrative allowances based upon payments received by the Plan from insured members. Such payments received by the Plan for the years ended December 31, 1987 and 1986 aggregated approximately $1,727,000,000 and $1,272,000,000, respectively.

The Plan also earned interest from the investment of funds representing payments received but not yet remitted to Prudential. For the years ended December 31, 1987 and 1986, interest earned by AARP from such investments amounted to $15,463,000 and $12,117,000, respectively.

Income from Other Programs and Services: Retired Persons Services, Inc. (RPS) is a separate unconsolidated entity sponsored by AARP, which operates twelve pharmacies across the United States, primarily for the benefit of AARP members. RPS pays royalties to AARP. At December 31, 1987 RPS was indebted to AARP for $640,000 plus interest at 7.75% due and payable on demand. The corresponding amount at December 31, 1986 was $1,120,000.

AARP sponsors a program of automobile and homeowners insurance coverage provided by The Hartford Insurance Company, resulting in royalties to AARP.

Travel-related services include AARP-sponsored car rentals from Avis, Hertz and National Car Rental companies. AARP also sponsors AARP Motoring Plan, which is provided by Amoco Enterprises Inc. and AARP Travel Service which is provided by Olson-Travelworld, Ltd. and R.F.D., Inc. AARP receives royalties from these programs based on services provided for AARP members.

AARP also derives income from AARP-operated educational programs, such as preretirement and driver improvement programs.

Operating Expenses:

Details of operating expenses are as follows:

	1987	1986
Salaries	$ 29,869,000	$ 25,635,000
Payroll taxes and employee benefits	7,058,000	6,379,000
Post-retirement health care benefits	6,851,000	3,000,000
Printing	50,738,000	46,990,000
Postage	47,117,000	41,025,000
Program support	9,607,000	10,165,000
Membership solicitation	7,272,000	7,792,000
Publications support	4,508,000	4,142,000
Office expense	4,564,000	4,127,000
Data processing	5,008,000	5,060,000
Rent	7,905,000	7,070,000
Staff travel	2,636,000	2,210,000
Expenses of national officers and volunteers	9,077,000	7,254,000
Telephone and utilities	1,616,000	2,061,000
Professional services	2,009,000	2,011,000
Public relations	6,024,000	5,591,000
Personnel administration	705,000	475,000
Board meetings and biennial convention	174,000	2,199,000
Nursing and retirement homes	312,000	461,000
Depreciation and amortization	3,286,000	2,677,000
Miscellaneous	1,275,000	985,000
Reimbursement of indirect government grant expense	(4,141,000)	(4,025,000)
Total operating expenses	$203,470,000	$183,284,000

Health Care Benefits: AARP provides certain health care benefits for active and retired employees, who meet current requirements. Substantially all of AARP's employees may become eligible for those benefits if they meet the requisite service and age requirements while working for AARP. Health care benefits for active and retired employees of AARP are provided through the AARP and RPS Employees' Welfare Trust.

The Trust receives contributions from participating employers to provide for current benefits based on expected costs of the Trust. For the year ended December 31, 1987, AARP contributions to the Trust for current health benefits were $2,170,000. In addition, during 1987, AARP accrued $6,851,000 relating to the projected cost of providing post retirement health care benefits for active employees.

Pension Plan: AARP participates in a multiple-employer non-contributory pension plan covering all employees after they qualify as to length of service. Plan assets, administrative expenses, and expected contributions have been allocated to AARP in proportion to the projected benefit obligation. AARP's general funding policy is to contribute an amount equal to or greater than the minimum funding requirements of ERISA, but not greater than the maximum deductible limit for taxable entities.

Effective January 1, 1987, AARP changed its method of accounting for pension costs to comply with Financial Accounting Standards Board Statement No. 87, "Employers Accounting for Pensions". Under this method, the amount funded exceeded 1987 pension expense by $949,000.

The following tables detail the components of net pension expense, the plan's funded status, and the amount included in AARP's balance sheet.

Components of net pension expense for 1987	
Service cost	$1,667,000
Interest cost	1,305,000
Actual return on plan assets	(2,532,000)
Deferred net asset gain	1,115,000
Net pension expense	$1,555,000

At December 31, 1987	
Fair value of plan assets	$22,546,000
Accumulated benefit obligation:	
Vested	(10,617,000)
Nonvested	(947,000)
Provision for future salary levels	(6,641,000)
Assets in excess of projected benefits	4,341,000
Unrecognized net gain	(3,392,000)
Prepaid pension cost in the balance sheet	$ 949,000

Major assumptions used at December 31, 1987 were: discount rate of 8.25%, expected long-term rate of return on plan assets of 8.50%, and salary increase 6.7%.

Commitments and Contingencies: AARP has contracts for production of Modern Maturity, its bimonthly magazine, and the monthly AARP and NRTA News Bulletins. The contracts are based upon minimum press runs, with annual printing cost of approximately $43,000,000 for Modern Maturity and the AARP and NRTA News Bulletins. The publications contracts also contain certain provisions for price escalations due to increased paper, labor and other operating costs. The contracts are cancelable upon termination of the publications or by 24 months written notice by either party but not before completion of the April/May 1993 issues.

AARP maintains office and warehouse facilities under long-term operating leases. Future minimum rental commitments, exclusive of additional operating costs and net of minor subleases in effect at December 31, 1987, are $7,211,000 in 1988; $6,995,000 in 1989; $6,680,000 in 1990; $4,889,000 in 1991; and $4,543,000 in 1992. For years 1993 through 1995, total commitments are $6,803,000.

REPORT OF INDEPENDENT ACCOUNTANTS

Price Waterhouse

March 3, 1988
Los Angeles, CA

To the Board of Directors
American Association
of Retired Persons

In our opinion, the accompanying balance sheet and the related statements of revenues, expenses and changes in fund balances and of changes in cash present fairly the financial position of American Association of Retired Persons at December 31, 1987 and 1986, and the results of its operations and the changes in its cash for the years then ended, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Price Waterhouse

Chairman PICKLE. Thank you very much, Mr. Guildroy.

Mr. GUILDROY. Thank you.

Chairman PICKLE. Now, the next panel will consist of Richard Ostuw, Curt Mikkelsen, and Fred Van Remortel.

Now, this panel consists of Richard Ostuw, vice president of the TPF&C. Now, what is that?

Mr. OSTUW. TPF&C is the Compensation and Benefits Consulting Division of Towers Perrin, which is a management consultant firm.

Chairman PICKLE. All right.

And Curt Mikkelsen. Mr. Mikkelsen represents the Washington Business Group on Health.

Mr. MIKKELSEN. That's correct.

Chairman PICKLE. And Fred Van Remortel represents Brown Bridgman & Co., Inc.

We will first receive testimony from Richard Ostuw.

STATEMENT OF RICHARD OSTUW, VICE PRESIDENT AND CHIEF GROUP ACTUARY, TPF&C, CLEVELAND, OH

Mr. OSTUW. Thank you, Mr. Chairman. I am happy to be here today. My name is Richard Ostuw and, as mentioned earlier, I am vice president and chief group actuary for TPF&C.

I also want to mention that I am here speaking on behalf of TPF&C, expressing our views. We consult with many large employers, but we don't suggest that we are here representing them today.

As has been discussed so far today, we have had a lot of discussion, and we will see a lot more on the emerging issues of company provided retiree medical benefits. We are undergoing a period of dramatic change.

Most large employers provide these benefits today. They certainly are very valuable to those who are covered under those plans, and also are very costly to the employers that sponsor them. But we should also recognize that few companies really understood the long-term cost implications of those benefits at the times they implemented them, largely during the sixties and seventies.

We have seen substantial increases in overall health care costs in recent years and, at the same time, we have seen companies undergoing substantial cost pressures largely because of a growing international flavor to competition.

Realistically, for a lot of companies, their ability to control their costs really will have a substantial effect on their ability to survive and to maintain their place and to continue to provide the benefits and compensation and jobs that they do now.

With postretirement medical benefits in particular, there has been a growing recognition of the long-term cost implications. Some of them has come because of maturing of the work force, as well as overall health care increases. And the work that the FASB has been doing has raised the level of awareness of the long-term costs really in saying that we should change the way we measure those costs.

We have done several hundred actuarial studies for clients, mostly large employers. In terms of changing the way we measure the expense of postretirement medical benefits, to say that if we

follow rules like the FASB will propose, what will be the expense impact? And for a lot of companies, the change in how we measure that expense will cause the expense to increase tenfold. For a lot of companies, that change in expense will represent 20 percent or more of their profits or after-tax earnings; that there will be a very major impact for a lot of companies to reduce their earnings if they make no other changes.

Some will say that this is merely a change in accounting practice, and it's true that the real cost of the plans is the benefits that are provided. And so when we change the way we measure the costs, it doesn't change the underlying costs. But, realistically, management and stockholders and potential stockholders measure earnings by the way they are published to a large extent. It certainly will influence what companies do.

I think, to a large extent, the challenge that companies face will be to strike a balance between, one, the needs of retirees for medical protection at an affordable price; and, two, the company's ability to absorb the increasing costs of the benefits that they now provide.

It will be a very difficult task. In my experience, large companies generally feel a very strong sense of responsibility to their retirees and their long-service employees. It will be very difficult for them to cut back on the commitment that may have been made. But many will feel that they just can't afford to absorb the cost increase, or some might say the true long-term cost of the level of benefit support that they've provided.

We think that a lot of companies will reach that conclusion, that they just can't afford that level of commitment and will have to make changes in what they're doing. And I view that really as a correction. I think companies, when they introduced these benefits in the sixties and seventies were well-intentioned. The benefits seemed to be valuable and of small cost.

Well, we now find that it is not of small cost, although we know it's valuable. And companies will need to strike a new balance between the benefit needs of retirees, current and future retirees, and their ability to support those benefits.

We should also recognize that a company should take on only a burden that it can afford; that if a company takes on a burden that it cannot afford, really everyone loses. Merely deferring that recognition doesn't take away the problem that we will face.

We expect that among large companies they will make a number of changes. We think some will continue the benefits that they now provide and absorb the cost increases. A few will terminate the plans they have, perhaps for current retirees, but especially for future retirees.

The larger group of companies though, I think, will take some middle ground. Some will make relatively moderate changes, either in the benefits that they provide, or the employees contributions that are required, or tightening up the on eligibility and definition of who is a retiree.

We think many of those changes will work to a way to relate either the benefits or the employee's contribution to each employee's length of service.

We think a lot of other companies though will make changes in the very nature of the benefits that they provide. And there has been some reference earlier today to go into some kind of a defined contribution basis.

We think one of the approaches that will be very attractive to a large number of companies is the so-called defined dollar benefit DDB program. Under that, the company offers the benefits, assuring access to retirees of availability of coverage. But the company's contribution is really separated. The company's contribution will be on the basis of a defined dollar amount.

And so the key element of that program will be in terms of the employer's contribution towards the cost of coverage in contrast to traditional defined benefit plans where the key commitment is to the level of benefits, where the company will absorb cost increases, but with the stated ability to cut back if that proves necessary.

We think by keying on the employer's contribution, employers will be able to make a commitment that they will be comfortable with, and they will be able to support on a long-term basis. And that will lead to stability in the plans that companies offer.

We think if companies don't do that, many of them will just delay problems and have to face them at a later time.

Companies probably, from time to time, will increase the level of their support on these defined dollar benefit promises to reflect inflation. But they will do so as they are able, much as they do now under pension plans with ad hoc increases to reflect increased cost of living by retirees.

We have seen some interest recently in companies wanting to advance fund for these benefit commitments, and we think that will grow, partly because companies now recognize the long-term obligation, and that they will find it prudent, once they expense for these plans on the advanced basis, to match the assets with the accruing liabilities, and also the issue of benefit security is a growing one.

There are just a couple of policy issues that I would like to express in my final comments.

One is that we feel that employers should be encouraged to provide or offer medical benefits to retirees for a number of reasons. One being that individuals with health problems will find it difficult or impossible to find affordable coverage through individual policies whereas, under group policies or group benefit programs, everyone is allowed access to coverage, and there is little or no denial or limitation based on prior health conditions.

The level of cost of individual policies is greater than under group plans because of adverse selection, and also the greater administration costs. Retirees without medical insurance will often become burdens to Medicaid and other programs and, therefore, the widespread availability of group coverage will relieve pressures on those governmental programs.

And as has been mentioned before, that medical benefits are based on need, related to health care needs, and related to the presence of dependents, and not related to income, and that in contrast to pensions in particular that the benefits are a different basis.

[The statement of Mr. Ostuw follows:]

STATEMENT OF RICHARD OSTUW, VICE PRESIDENT, TPF&C

Chairman Pickle and members of the House Subcommittee on Oversight, my name is Richard Ostuw, Vice President and Chief Group Actuary for TPF&C. TPF&C is the compensation and benefits consulting division of Towers Perrin, an international organization of management consultants, actuaries and reinsurance intermediaries offering a broad range of specialized services. Towers Perrin has been servicing clients in the area of employee benefits since 1917. Our consulting division currently works with approximately 8,000 clients. Among them are 98 of the Fortune 100 leading U.S. industrial companies, 405 of the Fortune 500 industrials and 365 of the Fortune 500 service companies. We have also completed consulting assignments in more than 130 countries around the world, including work for 100 of the 500 largest companies outside the U.S. However, I am here today representing TPF&C's own views and not the views of our clients.

Mr. Chairman, it is an honor to be here today to help identify the central issues involved in the policy debate pertaining to the subject of retiree health benefits. You and your distinguished colleagues are wise to consider this important issue. The decisions this committee makes regarding retiree health care benefits will be crucial to the well being of both companies and the workers they employ. In addition to my oral comments, I will be submitting a recently published study on retiree health care benefits developed by TPF&C. We hope this information will further assist you in your legislative efforts.

Background

We are entering a period of major change in company-provided medical benefits for retired employees and their dependents. Most large employers offer medical benefits to their retirees. These benefits are valuable to those covered and costly to their sponsors. Few companies understood the long term cost implications when they instituted these benefits.

Costs

Substantial increases in overall health care costs have occurred in recent years -- at the same time that companies have faced greater international competition. Many companies now believe that their very survival depends on their ability to control their costs. There is growing recognition of the substantial long term cost of post-retirement medical benefits. This result is largely due to the consideration by the Financial Accounting Standards Board (FASB) of a required change in accounting treatment. Based on several hundred actuarial studies conducted by TPF&C, the expense recognition for these benefits will increase tenfold for many companies. If they make no other changes, many will see 20% of their earnings or more wiped out by this expense. This change is "merely" a change in accounting treatment; the true long term cost of the plans would be unchanged. The change will, however, force companies to address this long term cost on an accelerated basis.

The Challenge

The key challenge for companies will be to balance (a) the needs of retirees for medical protection at an affordable price and (b) the company's ability to absorb the continually increasing cost.

This will be a very difficult task. Most large companies feel a responsibility to current retirees and wish to reward long service employees by assuring a comfortable retirement. But they must face the fiscal constraints imposed by international competition.

Many companies will conclude that they cannot afford to continue the same level of support that they provided in the past. Although the change will be difficult for all parties, it should be viewed as a correction. It may be of small consolation, but the security of post-retirement medical benefits depends on the fiscal integrity of the company. If the company assumes a burden that it cannot afford, everyone loses.

Expected Changes

We have assisted many large companies in addressing this problem. Based on that experience, we expect the following:

- A small number of companies will absorb the cost of continuing their present benefits.
- Some companies will terminate their benefits entirely.
- Many will make moderate changes such as reducing benefits, increasing the contribution required by retirees or restricting eligibility. In recognition of the substantial cost of the benefits, many companies will redesign their programs to relate benefits or contributions to the employee's length of service.
- Many other companies will make substantial changes in the nature of their benefits commitment.

One example of the last group is the Defined Dollar Benefit or "DDB" approach. Under a DDB program, the employer offers a medical plan to retirees and contributes a defined dollar amount toward the plan's cost. If the plan cost exceeds the employer contribution, the retiree must pay the balance in order to maintain coverage. The key element of the employer's commitment is the contribution amount -- not the deductible and other specific benefit features. Since this amount is not subject to uncontrollable cost increases, the employer can be more comfortable that it can afford the program and plan accordingly. As health care cost increases drive up the cost of the plan benefits, the employer may choose to grant increases in its defined dollar benefit. This element of cost control is vital for the long term vitality of the company. This approach to benefit increases is similar to the prevailing practice under pension plans. Another similarity to pension plans is that the company's DDB will commonly vary based on the employee's length of service.

Funding

With future requirements that companies adopt advance expensing policies and recognition of the plan liabilities, more and more companies will want to fund these costs. The two principal reasons are:

- to set aside funds to match the accruing liability for the benefits, as under pension plans, and
- to assure benefit security.

The desire to fund these liabilities has grown in the last few years. This is because of the recognition of the size of the liabilities and the change in perspective that the benefit is much like a pension. Previously, the general view was that the benefit was a year to year continuation of coverage.

Policy Issues

Employers should be encouraged to offer medical benefits to retirees. The reasons include the following:

- Individuals with health problems are assured of coverage under group plans but will commonly be denied coverage under individual insurance contracts.

- The level of cost under individual insurance is generally higher than group plans because of the adverse selection by applicants and the greater administration costs.

- Many individuals will need to purchase insurance to supplement medicare, even after the Medicare Catastrophic Coverage Act.

- Retirees without medical insurance become burdens to Medicaid and other governmental programs.

- Medical benefits are based on need, not income level, with greater benefits for those with dependents. By contrast, pension benefits are generally reflective of income level.

Companies should be encouraged to fund these benefit liabilities for the following reasons:

- The growing cash commitments of unfunded plans may strain the resources of companies in an economic downturn. For some, this commitment may be the difference between solvency and insolvency.

- Companies that go out of business with unfunded plans leave their retirees without coverage. Furthermore, those with health problems will be unable to secure other coverage. This would be especially critical for those not old enough for medicare.

Any legislation should retain flexibility for the employer to design and maintain a program appropriate for that organization. If funding limitations are needed, they should be compatible with a broad range of benefit plan approaches and employer situations. In addition, it should be noted that different types of funding limitations affect different population segments. For example, a limit that relates accumulated plan assets to plan liabilities has less impact on current retirees than current active employees. By contrast, limitation on the annual contribution for each employee would tend to disallow full funding for current retirees and active employees who are close to retirement.

Given our nation's changing demographics, post-retirement welfare benefits are likely to become a crucial employee benefits issue of the next decade. Employers and legislators must work together to achieve a proper balance between retiree needs and limited employer resources. We at TPF&C will be happy to provide this Committee with any additional information you may need and thank you for the opportunity to testify before you today.

Chairman PICKLE. Thank you, Mr. Ostuw.

We are going to proceed as quickly as we can, and I ask you to keep your testimony under 5 minutes. We have two more panels after this, so I would ask you to please try to move as quick as you can.

The next gentleman to testify will be Mr. Mikkelsen.

STATEMENT OF CURTIS MIKKELSEN, VICE PRESIDENT AND HUMAN RESOURCES BENEFITS AND RESEARCH MANAGER, MORGAN GUARANTY TRUST CO., ON BEHALF OF THE WASHINGTON BUSINESS GROUP ON HEALTH, ACCOMPANIED BY ROBERT LEVIN, DIRECTOR, INSTITUTE ON AGING, WORK, AND HEALTH, WASHINGTON BUSINESS GROUP ON HEALTH

Mr. MIKKELSEN. Thank you, Mr. Chairman.

My name is Curtis Mikkelsen and I am vice president and human resources benefits and research manager of the Morgan Guaranty Trust Co., the principal subsidiary of J.P. Morgan & Co., a New York-based financial institution. Today, however, I am representing the Washington Business Group on Health. I am accompanied by Robert Levin, Director of the Washington Business Group on Health's Institute on Aging, Work and Health.

One of the ways that we believe we can be most helpful to this subcommittee is by gauging and interpreting the concerns of our employer members on these issues. Three years ago this month, we presented the Senate Finance Committee with survey information showing growing employer concerns about retiree health care benefits.

Today, we see increasing employer activism in attempting to manage both the financial and the human resource issues surrounding the provision of retiree health benefits. Not only have companies come to recognize the growing costs associated with their plans, but they have taken steps to actively manage these costs.

Most importantly, our member companies have both reaffirmed a commitment to their retirees and have expressed a sincere interest in working with Congress to devise strategies which would permit employers to maintain a contributing role in the provision of these benefits.

By way of background, our survey results are based on responses from 83 companies. The median company surveyed has 18,000 employees and almost 5,000 retirees. Whereas, the final report will be issued this fall, preliminary results have confirmed what has been discussed and alluded to anecdotally for some time.

First, the proposed FASB accounting rules, coupled with soaring health care costs, will influence many employers to reduce benefits. Second, the modifications in plan design will be made primarily for active employees and new hires, rather than for current pensioners. This may well provoke concerns about generational equity in the distribution of health benefits.

In addition, the survey reveals strong employer interest in prefunding retiree benefits, given, of course, appropriate tax incentives. The surveys describes ways in which companies both prefer to implement this funding and under what regulatory parameters.

Of perhaps greatest interest to the Oversight Subcommittee is the apparent willingness of companies to accept some form of vesting as a quid pro quo for tax-favored financing. Let us now briefly address plan costs.

Our preliminary survey results indicate the average cost of providing health care benefits in 1987 for a retiree under age 65 approximated $2,800. This reflects a substantial 18 percent increase in costs for this pre-age 65 retiree group since 1986. For a retiree over age 65, the average cost in 1987 was about $1,000. This substantial drop in cost for the over age 65 contingent reflects the reality that Medicare spends about $3 for every $1 spent by the corporate plan for the post-age 65 retiree.

What is the anticipated impact of the FASB proposals on plan expense? Our member companies reported that their current average retiree health care benefit costs were about 2.7 percent of payroll. However, and importantly, subsequent to the anticipated FASB expensing requirements, the average cost was projected to soar to well over 8 percent. Very clearly, FASB's anticipated expensing and balance sheet requirements have now elevated retiree health care benefits to a senior management level concern.

Half of our respondents said they would reduce health care cover for current and future retirees if FASB requires balance sheet liability recognition. However, even absent FASB requirements, others indicated that they have or soon will be forced to reduce coverage because of sharply rising health care costs, at a time when controlling expense in a global marketplace has become an absolute business imperative.

A few comments now about plan design changes: Our member companies are actively investigating a variety of options. These include increasing years of service eligibility requirements, switching to a defined contribution plan, or a fixed annual dollar amount, increasing deductibles, coinsurance or premium contributions. Many firms also indicated they would expand wellness and other preventive health programs.

Most provocatively, about 40 percent of the firms surveyed intend within the next 2 years to provide a graduated benefit based on years of service. Only about 20 percent of the companies indicated they plan to transform their current plan design to a defined contribution or defined dollar approach. However, we suggest to you that these new types of plan design may become increasingly compelling. For the employer, obvious advantages of these approaches are that their liabilities can be more easily measured and costs can be managed. These approaches offer flexibility to the retiree, who can choose to spend the money on his own health care needs, be it Medicare catastrophic premiums, long-term care costs, or contributions to other retiree health care benefits.

Virtually all respondents said they would be interested in a tax-favored funding vehicle. However, most surprising to us, slightly over half of the survey respondents said they would be willing to support vesting requirements in exchange for tax-favored prefunding. Another 26 percent said they were not sure, but only 18 percent expressed no support for vesting.

It would be ironic if Congress, through repeated reductions in the Internal Revenue Code section 415 limits, increasingly forced pay-

as-you-go financing in the pension area at the same time it was encouraging companies to prefund postretirement health care benefits.

To cite a few other company concerns: Respondents expressed concerns with the design and financing of their retiree health care plans, as well as with overall congressional intent. Over three-quarters of the firms were "much more comfortable" in making plan design changes for active employees than for retirees.

Companies were also concerned about the intentions of government with regard to health care continuation coverage requirements. A substantial majority were concerned about the possibility that Congress would require employers to provide continuation coverage to all retirees not eligible for Medicare. We fully anticipate that employers would also react very unfavorably to any attempt to make employer-sponsored retiree health care benefits primary to Medicare coverage.

In general, employers remain very cautious with regard to sponsoring new forms of health care coverage. In another survey conducted by the Washington Business Group on Health, entitled "The Corporate Perspective on Long-Term Care," it was found that employer uncertainty as to future Government intentions was a major factor in discouraging employers from sponsoring group long-term care benefits.

Without clarity as to government intentions, employers are reluctant to take actions and plan for the future. We urge the subcommittee to recognize that it is the minority of firms that provide retiree health care benefits. Burdening the relatively small group of responsible employers reflects an excessive and, in our opinion, an unwarranted concern which may jeopardize the attainment of the more important public policy goal of improving access to health care for all citizens.

To conclude, providing employers with opportunities to prefund should not represent an opportunity for Congress to require still more of corporate America. Rather, Congress should help companies preserve the level of resource commitment that currently exists to help retirees meet their health care needs, then Congress should focus its energies on providing coverage to the uninsured and addressing long-term care needs.

In closing, I thank the Subcommittee on Oversight for this opportunity to appear before you. Robert Levin and I would be pleased to address questions or comments you may have about this presentation or the specifics of our survey.

Thank you.

[The statement of Mr. Mikkelsen follows:]

STATEMENT OF CURT MIKKELSEN, WASHINGTON BUSINESS GROUP ON HEALTH

My name is Curt Mikkelsen and I am Vice President and Human Resources Benefits & Research Manager of the Morgan Guaranty Trust Company, the principal subsidiary of J.P. Morgan & Co. Inc., a New York-based financial institution. Today, I am representing the Washington Business Group on Health. I am accompanied by Robert Levin, Director of the Washington Business Group on Health's Institute on Aging, Work and Health.

The Washington Business Group on Health is a not-for-profit association established in 1974 by major employers to address a broad range of health policy and health economic issues. Over the past few years, the WBGH has taken a keen interest in the topic of retiree health care benefits, both from the perspective of the concerns of its individual members, nearly all of whom provide health care benefits to their retired employees, and from the recognition of the important, social policy issues that a discussion of these benefits necessarily entails.

One of the ways that we believe we can be most helpful to this Subcommittee is by gauging and interpreting the concerns of our employer members on these issues. Three years ago this month, we presented the Senate Finance Committee with survey information showing growing employer concerns about retiree health care benefits. Then, as now, an ever-aging population, spiraling health care inflation, and changes in the Medicare program, were dramatically increasing the costs of company benefit plans. Added to this cost spiral were court decisions that implied a lack of employer flexibility in making benefit plan changes, signals from the Financial Accounting Standards Board (FASB) promising sweeping changes in accounting rules for retiree health care benefits, and a new tax policy which, through the Deficit Reduction Act, discouraged timely and proactive employer initiatives to address this emerging problem.

In many instances, unaware of the potential costs associated with their retiree health care plans, and largely assuming the right to modify those plans, employers were caught off-guard by the implications of providing retiree health care benefits. In September of 1985 it was still the exceptional company that had conducted an actuarial valuation to measure plan liabilities, and many firms were shocked to find that costs associated with their company's retiree health care plans were much higher than anticipated.

In revisiting Corporate America's attitudes and actions three years later, we perceive a sea change taking place with respect to retiree health care. In a new membership survey, preliminary results of which we are pleased to share with the SubCommittee today, we see a growing employer activism in attempting to manage both the financial and human resource issues surrounding the provision of retiree health care benefits. Not only have companies come to recognize the growing costs associated with their retiree health care plans, but they have taken steps to manage those costs. Most importantly, our member companies have both reaffirmed a commitment to their retirees, and have expressed a sincere interest in working with Congress to devise strategies which would permit employers nationwide to maintain a contributing role in the provision of retiree health care benefits.

The survey results, which are being presented for this hearing, are based on responses from 83 companies. Whereas a final report will be issued this Fall, preliminary results have confirmed what has been discussed and alluded to anecdotally for some time:

- Medical benefit costs for retirees are high, and increasing;
- The proposed FASB regulations will have material financial effects on many firms;
- Many companies, in the wake of the FASB pronouncements, may have no practical alternative to modifying plan design;
- The modifications in plan design will be made primarily for active employees and new hires, rather than current retirees, which will provoke concerns about generational equity in the distribution of health benefits.

In addition, the survey reveals a strong employer interest in prefunding health benefits given appropriate tax incentives, and describes ways in which companies would prefer to implement this funding, and under what regulatory parameters. Of perhaps greatest interest to the Oversight SubCommittee is the apparent willingness of companies to accept some form of vesting requirement as a quid pro quo for tax-favored financing.

Plan Costs

Preliminary survey results indicate that the average cost of providing health care benefits in 1987 for an active employee was $2,210. For a retiree under age 65, the average cost was $2,823. This reflects an 18% increase in costs for this pre-age 65 retiree group since the prior plan year. For a retiree over age 65, the average cost in 1987 was $1,036. This 63% drop in cost for an over age 65 retiree reflects the ameliorating affect of Medicare and underscores the reality that Medicare spends about $3 for every $1 spent by corporate retiree health care plans for post-age 65 retirees.

Impact of FASB Proposal

When the survey respondents were asked what their company's current post-retirement health care benefit costs were as a percentage of payroll, the average was 2.68%. When asked what these companies expected these costs to be, subsequent to the expensing requirements proposed by the FASB, the average was 8.13% of payroll -- a dramatic increase. Despite the number of compelling and competing health care issues facing Congress and Corporate America over the next few years, the potential costs and liabilities associated with FASB's anticipated expensing and balance sheet requirements have elevated retiree health benefits to a senior management level concern.

When asked if they would reduce health care coverage for current and future retirees if FASB requires balance sheet liability for these benefits, half of the respondents said they would. However, several also indicated they would have been forced to make changes due to sharply rising health care costs at a time when controlling expenses in a global marketplace has become a business imperative.

Plan Design Changes

As a means to control both current and future health care benefit costs, companies are investigating a variety of options to redesign their retiree health plans. These include increasing years-of-service eligibility requirements; switching to a defined contribution or a fixed annual dollar amount plan; increasing deductibles or coinsurance or premium contributions; and adopting managed care approaches. Many companies also indicated they would expand wellness and other preventive health programs.

Most provocatively, about 40% of the firms surveyed intend within the next two years to provide a graduated benefit whereby retirees are rewarded with increasingly generous coverage based on years of service. For example, an employee with 30 years of service might receive the maximum benefit available, whereas an employee with 20 years of service would have higher deductibles and coinsurance. Survey results show that the use of these graduated pension-like eligibility requirements may well be a prevailing form of new benefit redesign — primarily because it is one way to control the expansion of future liabilities with an increasingly mobile and aging workforce. It also represents a recognition of years of service as a criterion for benefit eligibility.

Defined Contribution Approach

While only about 20% of the companies indicated they plan to transform their current defined benefit style plan to a defined contribution or defined dollar approach, these new types of plan design may become increasingly compelling. For the employer, obvious advantage of these approaches are that their liabilities can be more easily measured and their costs can be managed. These approaches offer flexibility to the retiree, who can choose to spend the money on his own health care needs, be it Medicare catastrophic premiums, long term care costs, or contributions to other retiree health care benefits. Importantly, these approaches alleviate the need for Congress to legislate a minimum level of benefits in a health care delivery environment which is experiencing enormous change. There is of course, the transfer of risk to the retiree, but this may ultimately be helpful in providing incentives to restrain the rise in health care inflation.

Defined dollar or other defined contribution-type arrangements also permit benefit portability. An increasingly mobile workforce must be factored into future benefits legislation. Saddling the last company who hired an older employee with his or her future retiree health care benefit costs may be unacceptable, and these new approaches may well be necessary for our society.

Financing Option

Survey results show that 61% of the survey respondents indicated that while employers should be allowed to pay for and account for retiree health care benefits on a pay-as-you go basis, virtually all respondents (98%) said they would be interested in a tax-favored pre-funding vehicle for retiree health care benefits. Most (87%) indicated that a tax-favored health care trust would be preferable. Because more than one option could be checked in our survey, 41% indicated they would also be interested in a pension plan side fund, and 47% favored a pre-tax salary reduction plan, based on the 401(k) or IRA models. Only 6% indicated interest in Corporate-owned life insurance as a funding vehicle.

Vesting of Benefits

Most surprising, and in contrast to some of the public comment to date by certain employer groups, 56% of the survey respondents said that they would be willing to support vesting requirements in exchange for tax-favored prefunding incentives. Another 26% said they were not sure, and only 18% said no. Of those 56% who indicated they would support vesting requirements, 55% indicated that 10 years might be an appropriate eligibility requirement. The other 45% suggested a number of different variations.

This relatively broad expression of employer willingness to accept vesting requirements as a pre-condition for tax favored pre-funding reflects the interest of employers in working collaboratively with government in helping to solve retiree health care benefit financing problems. It also supports the thoughtful legislative initiatives that have been developed by Congressman Rod Chandler.

We do, however, urge Congress to recognize that pay-as-you-go expensing may be preferable to prefunding, if prefunding is tied to complicated ERISA-like requirements. We need prefunding to be valued by companies to have it serve its purpose — allowing companies to put aside money to help ensure the future provision of benefits. Indeed, it would be ironic if Congress, through repeated reductions in the I.R.C. Section 415 limits, increasingly forced pay-as-you-go financing in the pension area at the same time it was encouraging companies prefund post-retirement health care benefits. The two — income in retirement and health care benefits in retirement — are inextricably linked as forms of retirement income.

Company Concerns

In addition to rising health care costs and the proposed FASB regulations, respondents expressed other concerns with the design and financing of their retiree health care plans, as well as with overall Congressional intent. Over three quarters (76%) of the firms were "much more comfortable" in making plan design changes for active employees than for retirees. Constraints in making plan design changes included legal concerns (74%), employee relations (75%), corporate culture (53%), and competitiveness concerns (36%).

Companies were also concerned about the intentions of government with regard to health care continuation coverage requirements. Only 13% were "not concerned" with the possibility that Congress would require employers to provide continuation coverage to all retirees not eligible for Medicare. Although too obvious to ask in a survey, we fully anticipate that employers would also react very unfavorably to any attempt to make employer-sponsored retiree health care plans primary to Medicare coverage.

In general, although willing to accept compromises in exchange for tax-favored financing and other government support, employers remain quite cautious with regard to sponsoring new benefit entitlements and innovations. In another recent survey conducted by the Washington Business Group on Health, entitled "The Corporate Perspective on Long Term Care", it was found that employer uncertainty as to future government intentions was a major factor in discouraging employers from sponsoring group long term care benefits.

Without clarity as to what the government's intentions are, employers are reluctant to take actions and plan for the future. Quite apart from the successive waves of benefit-related legislation experienced since ERISA's enactment, the goverment has recently sent two chilling messages to employers, both of which hinder effective benefits planning.

First, under the HCFA regulations, which establish whether or not Medicare is the primary payer for former employees who are receiving employer-provided long term disability benefits, only those employers who have taken the positive step of continuing active employee medical coverage to disabled employees are now obliged to offer their plans as primary to Medicare. However, if an employer does not extend active medical coverage to disabled employees, then Medicare is primary and the employer incurs no additional liability. No doubt a company contemplating a long term care plan would be discouraged by this type of mandate.

Second, employers are now required to reimburse retirees for the value of the employer-provided retiree health care benefits that duplicate the newly legislated catastrophic Medicare benefits. Again, this only affects the employer that already provides generous coverage.

We urge the Subcommittee to recognize that it is the minority of firms that provide health care benefits to their retirees, and that only 25% of pre-Medicare eligible retirees and 16% of adults over the age of 65 receive employer-sponsored health care benefits. Burdening the relatively small group of responsible employers reflects an excessive and unwarranted concern which may jeopardize the attainment of the more important public policy goal of improving access to health care for all citizens. We believe that penalizing those involved in "best practices" should never be a public policy goal.

As some Congressional staffers have suggested, it may make sense to consider segmenting the retiree populations. First, governmental policymakers may well want to distinguish between those under the age of 65 and those over the age of 65 in determining legislation. Medicare-eligible retiree health care coverage has been strengthened by the recent catastrophic legislation. Those retirees who also have access to employer-provided retiree health care benefits are particularly well covered and in the minority. It is our belief, therefore, that employers providing health care to those over 65 should be allowed to alter those benefits and reallocate health care dollars more appropriately for long term care, wellness programs, and other needs of the Medicare-eligible population.

To conclude, providing employers with opportunities to prefund retiree health care benefit liabilities should not represent an opportunity for Congress to goad Corporate America into doing more than it is already doing. Rather, Congress should help companies preserve the level of resource commitment that currently exists to help retirees meet their health care needs. Then, Congress should focus its energy on providing coverage to the uninsured and addressing long term care needs. Changing demographics, increasing longevity, and workforce mobility should not be ignored in whatever social policy and legislative response is developed to address the expansion of health care coverage in the United States.

In closing, I thank the Subcommittee on Oversight for this opportunity to appear before you and would be pleased to address any questions or comments you may have about this presentation or the specifics of our recent membership survey on retiree health care issues.

Chairman PICKLE. Thank you, Mr. Mikkelsen.

We are going to have to take about a 10-minute recess to go over to vote, and then we will resume.

[Short recess.]

Chairman PICKLE. The Subcommittee will come to order.

We will now receive the testimony from Mr. Van Remortel, if you will continue.

Mr. VAN REMORTEL. With the indulgence of the Chair, Mr. Chairman, I would like to rearrange my verbal comments, in the interest of time, to avoid repetition or redundancy, and address two or three points that I sensed might be of particular concern to the Chair and to the committee.

Chairman PICKLE. You may proceed, and your entire statement will appear in the record.

STATEMENT OF FRED VAN REMORTEL, MANAGING DIRECTOR, RETIREE HEALTH CARE GROUP, BROWN BRIDGMAN & CO.

Mr. VAN REMORTEL. Brown Bridgman & Co. is an employee benefits consulting firm that has been in existence for 33 years. In respect to the retiree health care arena, we are operating within the framework of the joint venture that we have with Salomon Bros., Inc. The testimony today, our opinions today, however, express those of Brown Bridgman & Co.

The three points, Mr. Chairman, that I would like to address in very abbreviated comments are the questions that surround the liability itself and why one organization might define the liability at $400 billion and someone else might say $2 trillion, and it is not in and of itself a difficult explanation to give.

There are a lot of pieces in the quantification process with respect to the number of years that we are talking about, in respect to the assumptions that we make, particularly as far as the health care cost trend is concerned. Rarely have I seen a valuation exercise done by actuaries in quantifying the liability for a specific corporation where they have used a trend rate greater than 8.5 or 9 percent, and they have run a liability out for 20 or 25 or 30 years, yet we know this year health care costs being picked up by corporate America will increase from last year between 16 and 19 percent. Last year, they increased at a rate greater than 20 percent. The year before that, greater than 20 percent.

So, when we do the valuation exercise on the liability and assume a 7.5 or an 8 or a 9 percent rate of increase in health care costs, obviously the numbers will not jibe.

Now, the second point that I would like to address is what is happening in the corporate arena today, what are corporations doing in the existing legal environment to address the retiree health care issue.

Many corporations are continuing to do what we refer to as pay-as-you-go. They take the current period hit to earnings and go on to the next period. There are other corporations, particularly those of a smaller or medium size, that do not have a staggering liability per se, that is a balance sheet impact, but rather, they are concerned about the hit to the income statement, the earnings hit. Many of those corporations are utilizing what is referred to as a

COLI product, leveraged, corporate-owned life insurance contract. There are a few corporations around who have the unenviable position of having to make contributions to the pension trust. In those cases, they can use the 401(h) exclusion, 25 percent of that contribution to the trust being set aside for the funding of the retiree health care liability.

Over the course of the last year, I have come to be aware of 30 or 40 corporations who are utilizing 501(c)(9), that is, they are establishing the trust, they are making the contribution to the trust, that is a deductible contribution, the contribution coming off of the pretax income side of the income statement.

Now, with that contribution to the trust, one of two or three things happens. They can pay the unrelated business income tax. You raised the UBIT question a little bit ago. The unrelated business income tax in a trust environment is the trust tax rate 28 percent, 28 percent of those accumulated earnings go right off the top.

There are two ways to avoid unrelated business income tax in the 501(c)(9) environment. One would be for the corporation to direct that trust sponsor, the plan sponsor, if you will, to make that contribution an investment in triple tax-exempt municipal bonds—no taxable income, no unrelated business income tax. There are some obvious risks with that. One is the rate of return. We might even raise a question of, in respect to the current environment, preservation of capital.

There is, however, another way to avoid the unrelated business income tax, and that is to take that contribution and make that investment in a "life insurance contract." Let me emphasize, not a COLI contract, not a leveraged contract, not a policy loan borrowing stream contract, but rather, an insurance contract that is designed to go to the term of the contract, that is, the death of the insured.

What corporate America needs today, in the view of Brown Bridgman, is a vehicle for prefunding the retiree health care liability. It is only with assets set aside for the purpose of prefunding the liability that the balance sheet impact, soon to be recognized under the FASB rules, can be mitigated. It is only by the earnings accumulation of those contributions to the trust going to the income statement that will mitigate the income statement impact of current period expense.

I think it is important to note from a legislative perspective, what DEFRA did with UBIT and with very difficult actuarial rules in 1984 was not designed to restrict corporate prefunding of retiree health care liabilities. You were after abuses in the VEBA program, and nondiscriminatory funding of retiree health care promises is certainly not abusive.

The 1986 rules and OBRA changes and COBRA changes have all been designed to look at a specific piece of a specific problem, none of which has been prefunding of the retiree health care liability.

Thank you.

[The statement of Mr. Van Remortel follows:]

TESTIMONY OF FRED VAN REMORTEL
MANAGING DIRECTOR, RETIREE HEALTH CARE GROUP
BROWN BRIDGMAN & COMPANY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
OF THE HOUSE OF REPRESENTATIVES
SEPTEMBER 15, 1988

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I AM PLEASED TO HAVE THIS OPPORTUNITY TO PRESENT MY VIEWS ON THE ISSUE OF RETIREE HEALTH CARE BENEFITS.

BROWN BRIDGMAN & COMPANY IS A 33-YEAR-OLD EMPLOYEE BENEFITS CONSULTING FIRM THAT ADDRESSES MULTIPLE EMPLOYEE BENEFITS MARKETS ACROSS THE UNITED STATES AND SERVES A BROAD SPECTRUM OF CORPORATE CLIENTS. ONE OF THE THREE PRIMARY MARKETS WE SERVE IS THE RETIREE HEALTH CARE ARENA.

THROUGH OUR JOINT VENTURE WITH THE PENSION SERVICES GROUP OF SALOMON BROTHERS INC, WE HAVE DISCUSSED THE RETIREE HEALTH CARE ISSUE WITH OVER 100 OF THE FORTUNE 300 CORPORATIONS. CORPORATIONS HAVE COME TO REALIZE THAT THE PREFUNDING OF RETIREE HEALTH CARE IS AN EMERGING CORPORATE DILEMMA, VIRTUALLY UNIVERSAL FOR ALL CORPORATIONS. MOST COMPANIES KNOW THAT THEY HAVE INCURRED A SIZABLE LIABILITY FOR THEIR HEALTH CARE BENEFIT PROMISES TO EXISTING AND POTENTIAL RETIREES. WE HAVE FOUND THAT MOST CORPORATIONS HAVE COMPLETED AN EVALUATION OF THEIR LIABILITY -- THEY ARE FULLY AWARE OF THE PRESENT VALUE OF THEIR 30-YEAR LIABILITY. IN FACT, THE COMBINED LIABILITY FOR THE FORTUNE 500 IS ESTIMATED TO RANGE FROM $1.5 TO $2 TRILLION. THIS LIABILITY HAS GROWN AT A RATE IN EXCESS OF 20 PERCENT PER YEAR AS A RESULT OF INCREASING HEALTH CARE COSTS, EARLY RETIREMENT, AND LONGER LIFE SPANS.

TYPICALLY, MOST CORPORATIONS PAY CLAIMS AND/OR INSURANCE PREMIUMS OUT OF CURRENT PERIOD EARNINGS TO COVER THIS LIABILITY. THESE AMOUNTS ARE BECOMING PROHIBITIVE, AND WHEN EVALUATED ON A PROSPECTIVE BASIS, THEY ARE ALARMING. AS A RESULT, THE FINANCIAL ACCOUNTING STANDARDS BOARD IS EXPECTED TO ISSUE AN EXPOSURE DRAFT OF A NEW RULE THAT WOULD REQUIRE PUBLIC CORPORATIONS TO QUANITIFY AND RECOGNIZE THIS LIABILITY ON THEIR BALANCE SHEETS. CORPORATIONS UNDERSTAND THAT TO DO SO WITHOUT PROVIDING SOME FORM OF PREFUNDING OR AN OFFSETTING ASSET WOULD SEVERELY DISCOUNT THE ASSET VALUE OF MOST CORPORATIONS, REDUCE THEIR EQUITY VALUE, AND RESTRICT THEIR CREDITWORTHINESS.

BROWN BRIDGMAN EXPLORES, WITH AND FOR CORPORATIONS, ALL EXISTING PREFUNDING OPTIONS: 401(h) EXCLUSIONS TO THE PENSION TRUST, 501(c)(9) [VEBA], 501(c)(9) USING A LIFE INSURANCE PRODUCT, AND CORPORATE-OWNED LIFE INSURANCE. CORPORATIONS STATE THAT PRUDENT FINANCIAL MANAGEMENT DICTATES THE PREFUNDING OF THE RETIREE HEALTH CARE LIABILITY. THAT IS, ASSETS -- EARNING ASSETS ARE SET ASIDE TO COVER THE RETIREE HEALTH CARE LIABILITY MUCH LIKE A PENSION TRUST.

INITIALLY, WE SUGGEST THE USE OF A 401(h) EXCLUSION TO A CORPORATION THAT IS IN A POSITION TO CONTRIBUTE TO ITS PENSION TRUST. TWENTY-FIVE PERCENT OF THAT CONTRIBUTION CAN BE EARMARKED FOR THE RETIREE HEALTH CARE LIABILITY. UNFORTUNATELY, MOST CORPORATIONS CANNOT USE THIS MEANS OF PREFUNDING BECAUSE THEY CANNOT MAKE ADDITIONAL CONTRIBUTIONS TO THEIR PENSION TRUSTS DUE TO THEIR OVERFUNDING. ADDITIONALLY, 25 PERCENT OF ANNUAL TOTAL CONTRIBUTIONS IS TYPICALLY AN AMOUNT TOO SMALL TO COVER THE ENTIRE COST OF THE LIABILITY OVER A REASONABLE LENGTH OF TIME.

SECOND, THE USE OF VEBAs (501(c)(9) TRUSTS) HAS BEEN SOMEWHAT LIMITED BY THE DEFICIT REDUCTION ACT OF 1984. IN THE PAST, EMPLOYERS COULD DEDUCT CONTRIBUTIONS TO VEBAs FROM THEIR PRETAX INCOME, AND THE INTEREST ON VEBA EARNINGS WAS TAX-FREE. THROUGH DEFRA, AN UNRELATED BUSINESS INCOME TAX [OR UBIT] WAS APPLIED TO THE EARNINGS, EFFECTIVELY LIMITING MOST CORPORATIONS' USE OF VEBAs AS A PREFUNDING VEHICLE. CURRENTLY THERE ARE COMPANIES THAT CONTINUE TO USE VEBAs AS A PREFUNDING VEHICLE IN SPITE OF THE DISADVANTAGE OF PAYING TAX ON EARNINGS.

THIRD, WE DISCUSS WITH OUR CLIENTS THE USE OF A 501(c)(9) TRUST WITH LIFE INSURANCE. REGULATIONS SURROUNDING THE USE OF 501(c)(9) ARE NOT AS ONEROUS AS GENERALLY BELIEVED. CERTAINLY, THE RULES SURROUNDING 501(c)(9) ARE DIFFICULT, BUT NOT IMPOSSIBLE. THE LEVELS OF FUNDING UNDER 501(c)(9) AND 419A GIVE CORPORATIONS A GOOD START ON PREFUNDING THIS LIABILITY. THE 501(c)(9) UBIT CAN

BE AVOIDED IN ONE OF TWO WAYS: A CONTRIBUTION TO THE TRUST CAN BE INVESTED IN A TAX-EXEMPT MUNICIPAL BOND OR IN A LIFE INSURANCE CONTRACT, PREFERABLY A LIFE INSURANCE CONTRACT SPECIFICALLY DESIGNED FOR USE IN CONJUNCTION WITH 501(c)(9). THE LIFE INSURANCE CONTRACT INSIDE OF A TRUST IS NOT A "COLI" CONTRACT: NO POLICY LOANS, NO PARTIAL WITHDRAWALS, NO EARLY SURRENDERS. IT HAS NONE OF THE ABUSES ADDRESSED IN THE TAX REFORM ACT OF 1986 [OR TRA 86] -- THE FUNDING OF NONDISCRIMINATORY BENEFITS, OR IN THE TECHNICAL CORRECTIONS BILL OF 1988 -- THE SINGLE-PREMIUM ABUSES ADDRESSED BY REPRESENTATIVES ROSTENKOWSKI, STARK, AND GRADISON. WE ADVOCATE A LIFE INSURANCE CONTRACT SPECIFICALLY DESIGNED TO WORK WITHIN A 501(c)(9) TRUST. THE CONTRACT IS HELD TO THE DEATH OF THE INSURED.

A FOURTH OPTION THAT BROWN BRIDGMAN ONCE ADVOCATED WAS THE PREFUNDING OF RETIREE HEALTH BENEFITS THROUGH THE PURCHASE OF CORPORATE-OWNED LIFE INSURANCE. THIS METHOD OF PREFUNDING WOULD BENEFIT THE SMALL TO MEDIUM-SIZE CORPORATION WITHOUT AN EMORMOUSLY LARGE RETIREE HEALTH CARE BALANCE SHEET LIABILITY, THE CORPORATION CONCERNED NOT SO MUCH WITH THE BALANCE SHEET IMPACT BUT WITH THE INCOME STATEMENT IMPACT. THE TAX REFORM ACT OF 1986 IMPOSED A $50,000 CAP ON THE DEDUCTIBILITY OF POLICYHOLDER LOAN INTEREST THEREFORE LIMITING THE PRIVATE SECTOR'S OPTION TO PREFUND THE LIABILITY IN THIS MANNER. THE USE OF CORPORATE-OWNED LIFE INSURANCE TO PREFUND WOULD ALLOW FOR THE SPREADING OF THE DEDUCTION OVER THE LIFE OF THE BENEFIT STREAM THEREFORE ELIMINATING A FRONT-SIDE HIT TO THE TREASURY ESPECIALLY IN THIS ERA OF INCREDIBLE FEDERAL BUDGET DEFICIT.

REPRESENTATIVE HAL DAUB, A MEMBER OF THE COMMITTEE ON WAYS AND MEANS, SAW THE ADVANTAGES TO THIS PREFUNDING ALTERNATIVE AND INTRODUCED H.R. 3778, WHICH REMOVES THE $50,000 CAP SOLELY FOR THE PURPOSE OF PREFUNDING THE RETIREE HEALTH CARE LIABILITY IN A NONDISCRIMINATORY MANNER. HIS LEGISLATION IS SUPPORTED BY MEMBERS OF THE HOUSE COMMITTEE ON WAYS AND MEANS. ADDITIONALLY, SENATOR PATRICK LEAHY HAS RECENTLY INTRODUCED COMPANION LEGISLATION IN THE SENATE.

FINALLY, WE FIND THAT THE MEASUREMENT AND RECOGNITION RULE CHANGES BEING IMPOSED BY FASB, ON THE WHOLE, ARE VERY REASONABLE. THE DOOM AND GLOOM SPOKEN BY MANY BENEFITS CONSULTANTS IMPLYING OR PREDICTING THAT MAJOR CORPORATIONS WILL TERMINATE THEIR HEALTH CARE PROMISES BECAUSE OF THE REQUIREMENT TO RECOGNIZE THE LIABILITY ASSOCIATED WITH THOSE PROMISES IS NOT SUPPORTABLE. WHAT CORPORATIONS REQUEST AND MUST HAVE IS A MEANS TO EFFICIENTLY MANAGE THE LIABILITY -- THEY DON'T WANT TO ABROGATE THE RESPONSIBILITY -- THEY WANT TO MANAGE THE LIABILITY. CORPORATIONS MUST HAVE ACCESS TO TAX-DEDUCTIBLE FUNDING OF RETIREE HEALTH CARE RESERVES. THEY MUST HAVE TAX-FREE EARNINGS ACCUMULATIONS ON THOSE ASSETS. WITH THAT, CORPORATIONS CAN MITIGATE THE IMPACT OF FASB-MANDATED BALANCE SHEET RECOGNITION. THE EARNINGS ON THOSE ASSETS WILL OFFSET THE INCOME STATEMENT IMPACT OF EXPENSING RETIREE HEALTH CARE COSTS.

U.S. INDUSTRY DOES NOT NEED NEW LEGISLATION TO EFFICIENTLY OR EFFECTIVELY FINANCE POST-RETIREMENT HEALTH CARE BENEFITS. I AM HERE TO RESPECTFULLY REQUEST THAT EXCEPT FOR THE $50,000 LOAN CAP, THIS SUBCOMMITTEE TAKE NO ACTION AT LEAST UNTIL THE REGULATORY, THAT IS, FASB, DIRECTION IS CLEAR AND IN PLACE. U.S. CORPORATIONS CAN CREATE A PENSIONLIKE FUNDING VEHICLE THAT PROVIDES FOR A TAX-DEDUCTIBLE CONTRIBUTION AND TAX-FREE EARNINGS ACCUMULATION IN EXISTING LAW. NEW LEGISLATION AT THIS TIME WILL CERTAINLY COMPOUND THE PROBLEM RATHER THAN SOLVE IT. FURTHER TAX INCENTIVES ARE COSTLY TO THE U.S. TREASURY AND MORE IMPORTANTLY WILL BE COMBINED WITH PROVISIONS FOR MINIMUM BENEFIT LEVELS, VESTING, AND PORTABILITY. THE RESULTS WOULD BE AN EVEN RICHER BENEFIT PROMISE, DRAMATICALLY INCREASING THE LIABILITY FACING AMERICAN CORPORATIONS. LET US SOLVE OUR CURRENT PROBLEM WITH THE TOOLS WE HAVE, LET US NOT EXACERBATE IT WITH PREMATURE LEGISLATION.

MR. CHAIRMAN, I REQUEST THAT AN ADDITIONAL WRITTEN STATEMENT BE INCLUDED IN THE PRINTED RECORD OF THIS PROCEEDING.

Additional Written Statement

Retiree Health Benefits: Is Time Running Out?

By

Fred Van Remortel
Managing Director
Retiree Health Care Group
Brown Bridgman & Company

Fifteen or twenty years from now, corporate executives may look back on 1988 as a turning point in employee relations. Occasionally, an opportunity arises that is so compelling, so demanding of attention, that managers will take the actions necessary to confront the challenges of the moment. The crisis in retiree health benefits is such a challenge, and 1988 is the year to begin facing up to the benefit promises made twenty, thirty, or more years ago.

One cannot turn back the clock. Managers in the year 2000 will remember 1988 as a bellwether--the year in which, for the first time, the health care liability of some American corporations exceeded their liability for pension benefits.

This may be the year that corporate America begins turning the corner, the year it puts retiree health plans on a sound financial footing. If not, 1988 may be remembered, regretfully, as an opportunity squandered and the beginning of the end of the healthy corporate bottom line.

The cost of health care in the United States is dangerously out of control. As a nation, we spend about 11 percent of our gross national product on our health care delivery system, double the spending level of our major trading partners. If the rate of growth continues unchecked--and there is little reason to think it won't--the national health care bill will reach a staggering $1.9 trillion, or 15 percent of the GNP, by the year 2000. Resolving this predicament requires some uncomfortable choices: ration or curtail services, default, or find another way to pay the bill.

In reality, we have reached that crossroad, and corporate CEOs must grapple with the choices--decisions must be made. The reasons are threefold: Americans are retiring earlier than ever before; people are living longer; and much of the burden for their continued health care, even among retirees over age 65, falls squarely on the shoulders of private employers, not on the federal government.

Compared to corporate-defined benefit pension plans, retiree health benefits are volatile and unpredictable because they are open-ended, subject to the inflationary spiral that shrouds health care costs. The net effect is that each additional retiree covered by a health care promise is an annual expense for the employer, a continuing expense from which the employer cannot easily walk away.

Example: A $12 billion New Jersey company expects to spend $60 million in 1988 for its 50,000 retirees--an average of $1,200 per retiree. However, this $60 million is nowhere near the cost of maintaining health benefits in future years, assuming current inflation trends continue unabated. And $60 million is but a fragment of the cumulative cost of health insurance benefits for all 50,000 retirees over their expected lifetimes.

The shortfall of available cash or other assets to meet future years' coverage worries employers. Compounding that worry is a draft rule pending before the Financial Accounting

Standards Board, the standards-setting body for the accounting profession, that would require employers to report unfunded health benefits as a balance sheet liability.

Becoming a Corporate Responsibility

How did so many companies, particularly Fortune 500 companies, arrive at this unenviable position? There are several reasons. Corporations did not recognize the financial magnitude of their health care promises. They ignored the explosive growth of the cost of those promises, and the liability got out of control. In addition, legislative action inadvertently discouraged prefunding that health care liability.

Ironically, it was federal tax policy that originally encouraged employers to extend health care to retired workers, by allowing them to deduct health benefits paid from pretax income. In the years following World War II, Congress found the tax code a potent weapon in motivating employers to offer health care benefits, ensuring the nation a stable work force as it began moving into full industrial production.

Forty years later, Congress is using the tax code again as an instrument of social change, but the agenda is different: keeping the Treasury's coffers full enough to finance a trillion-dollar federal spending program, while trying to manage a ballooning budget deficit.

In attempting to balance the books, Congress has handcuffed corporations, making it more difficult for the few companies that recognize the health benefit liability to address it. The Deficit Reduction Act of 1984 imposed a tax on income earned by the voluntary trusts then used by some companies to prefund retiree benefits. The Comprehensive Budget Reconciliation Act dropped another red flag by casting private employers in the role of primary health care provider, supplanting Medicare, for workers over 65.

Last year, the administration proposed to tap the excess reserves in defined benefit pension plans, reserves accumulated through the run-up in stock prices over the previous five years. That innovative solution ran afoul of objections from labor unions and the American Association of Retired Persons and was immediately sidetracked. Coincidentally, the October 19th stock market decline reduced much of the surplus.

The federal Medicare program, enacted in 1965 to provide adequate medical care for the nation's elderly, did not offer the relief its drafters envisioned. Today, Medicare covers only 40 percent of health care costs, for persons over the age of 65, leaving the individual or the corporation to pay the balance.

Becoming a Competitive Issue

Health care is a complex and increasingly expensive issue that stubbornly resists cost-control efforts. Life-saving medical technology performs wonders in the operating room, but at a cost. The over-65 age group, while only one-eighth of the nation's population, accounts for one-third of the nation's total health care bill. Yet another reason why hospitalization costs continue to soar unchecked is that public hospitals routinely pass along, in the form of higher service fees, the cost of caring for the 37 million Americans without medical insurance.

Early retirements, far from reducing the costs of retiree health benefits, have become a wholly unscheduled burden for employers. In a 1987 study, the Employee Benefit Research Institute reported that a worker retiring at 55 will cost the employer twice as much over his or her lifetime as someone retiring at 65. Longer life expectancies increase a company's liability; a worker retiring at 65 today can expect to live to 80 1/2, about ten years longer than a worker retiring at age 65 in 1945.

Employee and retiree health benefits have over the years become a drag on corporate earnings throughout all major industries, falling heaviest on the "smokestack" industries that in the last decade restructured to remain competitive. A well-known automobile manufacturer spends about 10 percent of the price of each new car on employee and retiree health care; in fact, its largest single vendor is a health care provider. Another automobile company estimates it spends about $600 on health care for every car it sells.

Many companies, like the New Jersey manufacturer with 50,000 current retirees, report that health care costs, which rose by 24 percent in 1987, are a significant drain on earnings, hampering their ability to compete with foreign producers. If forced to accrue the unfunded liability as a balance sheet item, many corporations could see as much as 70 percent of their shareholder market capitalization disappear.

Too Few Supporting Too Many

The retiree health issue mirrors a problem faced by the Social Security Administration: too few active workers to support today's retirees. There will be even fewer active workers tomorrow. In 1974, there were twelve workers for each retiree collecting health benefits. Today, in Fortune 500 companies, the ratio is only three to one; by the year 2000 the ratio will be closer to two to one.

Options for the CEO

Eventually, companies will have to confront their liability for unfunded health benefits, and the sooner the better because that cumulative exposure becomes progressively larger, and more unwieldy, with each passing year. Whether the business community can look to Congress for help is, at best, uncertain. While Congress is studying the situation carefully, the federal government has its own health care liability for its civilian and military retirees, a liability that equals or exceeds that of private U.S. corporations. Congress, though, is well tuned in to the needs of older Americans, as evidenced by the overhaul of the Medicare system enacted last summer, the first significant expansion of Medicare in its 23-year history.

Restructuring Benefits Is Not the Only Solution

Corporate CEOs have several options. They can restructure retirement health plans for current employees by linking paid benefits to an employee's length of service, or by switching from defined benefit to defined contribution plans (in which the employer is not obligated to pay the full amount).

Corporations can also try to modify existing agreements covering current retirees, if their labor contracts allow modification, by sharing some of the cost increases directly with retirees. This could be accomplished through higher deductibles or by limitations on insurance coverage. However,

as the work force shrinks and the competition for good employees intensifies, a strong health care benefits plan will become essential to attracting and retaining skilled employees.

Moreover, restructuring is not an easy task. The courts have held employers accountable to collective-bargaining agreements with labor unions, making it difficult to modify postretirement health benefits unless that right is specifically granted. An employer cannot unilaterally tear up an agreement and walk away from its obligation. The LTV bankruptcy put employers on notice. When LTV Corporation, in chapter 11 reorganization, revoked its retiree health benefits, Congress enacted legislation forcing LTV to reinstate those benefits.

The history of labor relations over the last decade is one of protracted struggle, with big labor fighting against company "give backs" of wages and benefits, and employers grappling to revitalize stagnant industries and to meet foreign competition, while keeping their shareholders happy.

Modifying benefits for retirees or limiting future payouts through vesting plans, cost sharing, or other methods are at best short-term solutions. Vesting limits eligibility of coverage to employees meeting certain minimum service requirements. Cost sharing shifts part of the health care burden to the retiree but does not ensure that funds will be there to pay the bill in ten years.

Prefunding Is a Vital Part of the Solution

A more pragmatic, long-term approach is to plan now for the needs of tomorrow. Corporations can recognize their long-term obligation to their retirees and start setting aside assets to meet this obligation. By shifting from pay-as-you-go funding to an actuarially sound prefunding plan, companies can keep the health care promises in much the same way they do pension promises: by placing assets into a separate trust for retiree health care. By establishing such a trust, corporations can offset the impact of the balance sheet recognition, and the earnings of the trust assets can offset the current period expense.

Over the longer term, the only adequate solution to this dilemma is one that allows reserves to be accumulated on a pretax basis. This option is available today; yet, remarkably, 95 percent of American corporations are not prefunding postretirement health plans. Why are they not taking such a logical step?

Several years ago, when Brown Bridgman first examined the retiree health issue, few companies realized the extent of their liability. Virtually no corporations were addressing the issue. And on Capitol Hill, virtually no one was aware of the magnitude or universality of the problem. FASB rule number 81 simply required that companies put the current period's retiree health care cost in a footnote to their annual reports.

More importantly, most corporate officers are not aware that viable prefunding options now exist. They share the common misconception that the Deficit Reduction Act's tax on voluntary employee beneficiary associations destroyed the effectiveness of those trusts. Few know that it is possible to prefund retiree health benefits through tax-deductible contributions to a 501(c)(9) trust while complying fully with the Internal Revenue Code.

The threat of a FASB ruling requiring companies to accrue future health benefits on their balance sheets has finally

caused corporations to wake up and take notice of reality. Although most have now brought in consultants to calculate their future liabilities, few have done anything other than revise their benefits plans. They are waiting for FASB to crack the whip before acting.

Solutions Must Be Implemented Now

In fact, the most efficient way for corporations to manage this liability is a seven-, ten-, or fifteen-year prefunding plan that incorporates the following: The establishment of a trust the contributions to which are tax-deductible. The assets of the trust must be segregated and legally restricted to provide the retiree health care benefit. Those assets will be eligible for balance sheet recognition so the impact of the upcoming FASB mandate is reduced or eliminated. Earnings accumulation on those assets must be tax-free, and the earnings accumulation must be eligible for income statement recognition so that the current period hit to earnings generated by retiree health care expenses are reduced or eliminated.

Current tax law allows such a program to be put in place today.

Regardless of the rules and the timing for implementing those rules by FASB, the liability confronting corporate America in real terms will not be significantly altered. Corporate leadership and the leadership of organized labor must collectively recognize the urgency of the retiree health care dilemma and work together today to implement a two-pronged solution: restructuring and prefunding.

There is no need, and no time to wait for governmental solutions. Action must be taken now to avoid a financial and social crisis twenty years from now. Time is indeed running out.

* * *

This concludes my prepared remarks.

Chairman PICKLE. Thank you, Mr. Van Remortel.

Let me ask one or two questions and then maybe I can come back to you. Mr. Ostuw, you said in your statement that there was a growing recognition of the substantial long-term cost of these retiree health benefit programs, and that concern was growing at an alarming rate because of the pending issuance by FASB of accounting statements.

Now, earlier today, the GAO and the EBRI both testified that corporate retiree health liabilities already exceeded $200 billion, up to $400 billion, and possibly $1 trillion. Corporate America simply does not show any of that liability on their books. How could it be that corporate America has not listed any of this as liability or shown any recognition of this kind of sum of money except by asterisk or footnote?

Now, $400 billion, that is larger than our national defense program, and yet there is no recognition of that. Do you think they should recognize it, and what would be wrong with FASB just reporting, that is their recommendation, that it should be made accountable and shown as liability? Do you object to that?

Mr. OSTUW. No, I would not object to the FASB conclusion merely being that companies should disclose the obligation. I think it is up to them. They are in a better position, I would say, than I am as far as determining whether it should be a charge against earnings or merely be publicly reported.

I think the reason it has grown so large, without more recognition in the past, is that there has been a change in perspective in really the last few years. Until then, it was viewed as really a year-by-year extension of coverage. It was not viewed as a long-term obligation and therefore was not viewed as a liability.

Chairman PICKLE. I think I would agree with you, that we have just kind of, all of us, looked the other way and have not faced up to the fact that this is a growing liability. It seems to me, though, that the companies made the promise, made the commitment—not the Congress, not the individual—the company did it because it was good public policy and they wanted to help. They have done it and they have just expensed it off, but they do not want to take into account the fact that it is a liability. They do not want to show it.

I will ask you or any of the panelists, what is wrong with publicly showing that as a liability, if it is a liability? And here GAO and EBRI are saying it is a liability. What is wrong with publicly disclosing it? Does anybody have any objection to that?

[No response.]

All right, then we will go on then to another question. I noticed, Mr. Mikkelsen, you stated in your statement that many of your companies were thinking about switching from a defined benefit to a defined contribution plan, and I read your statement in that area and you said that the reason for this switching over may be compelling, it has more flexibility and you gave other reasons for it.

That may well be a development. My question to you is tell me how that would work. Why would there be a desire to shift over to a contribution plan? Is it just because the choice that the individual has?

Mr. MIKKELSEN. Rather, I think the rationale—and in my opinion this is a rather compelling one—is that when you contemplate the current defined benefit style retiree health benefit plan, it is not dissimilar from a defined benefit pension arrangement which is fully indexed at rates of health care inflation which are out-stripping the underlying rate of increase in the CPI by a dramatic extent.

I think that the advantage of the defined contribution on the defined dollar benefit approach that Mr. Ostuw spoke to is that you are able to achieve cost management objectives, objectives you are not often able to attain with a defined benefit style arrangement.

Chairman PICKLE. What would be wrong if the defined contribution program did grow, because if it gave the individual the right to choose how he would want his health benefits costs met, I would think that——

Mr. MIKKELSEN. I am having difficulty hearing you, Mr. Chairman. Would you repeat your question, please?

Chairman PICKLE. I did not hear you, I am sorry.

Mr. MIKKELSEN. I too was encountering difficulty hearing you, sir. Would you repeat your question, please?

Chairman PICKLE All right. I said what would be wrong if the defined contribution program did grow, because if it gave the individual the right to choose how he would want his health benefits costs met, I would think that there would be some reason to perhaps develop that kind of program.

Some of the organizations just previous to that said no, we must keep the defined benefit. Now, tell me, how do these defined contribution plans work? How would it work? Why would you say that it might be advantageous to the individual?

Mr. MIKKELSEN. It would afford the individual flexibility in that he would have a dollar-based plan of benefits from the plan's sponsor. He could then take those dollars and direct them in various ways.

Under the current defined benefit arrangement, he is entitled to a plan of benefits, expressed as various hospital, surgical, major medical-type coverage.

Chairman PICKLE. All right. I presume that under defined benefit, the individual is better off if medical costs go up, he would probably rather keep that program.

All right. Mr. Chandler?

Mr. CHANDLER. I believe, in the interest of the hour, that I will defer, Mr. Chairman, to move on to the next panel. Thank you.

Chairman PICKLE. All right. Mr. Flippo, do you have any questions?

Mr. FLIPPO. No questions.

Chairman PICKLE. I would say lastly to you, Mr. Van Remortel, you seem to be endorsing Mr. Daub's program. You would say that relief ought to come by virtue of establishing some kind of a prepayment program or prepayment system.

Mr. VAN REMORTEL. I think, Mr. Chairman, prefunding is essential. I think, further, that it should take two or three or four forms that are appropriate to different market segments. For example, the Fortune 500 have very, very comprehensive health care plans, they have staggering liabilities. Over the last 8 months, I have

talked to over 110 of the Fortune 200. I have seen liabilities that range from $1 billion to in excess of $7 billion in one company a major balance sheet impact.

There must be a program where asset values, hard asset values will mitigate the impact of that balance sheet recognition. The smaller companies, where the expense is the bigger concern, other programs would be appropriate.

Chairman PICKLE. I can see your recommendation. You want some of it paid by 401(h)—Mr. Chandler recommends that—or an offshoot of the VEBA, or through life insurance or removing the COLI cap. Here again, both Mr. Daub and Mr. Chandler would do that, and I guess Mr. Flippo would, too. All that may be well to be considered if the Federal Government gets into it. I do not know to what level we are going to get involved in this.

You companies promised these benefits, you started them off voluntarily. I do not know why you should be surprised now to say these losses or these liabilities are staggering. You staggered yourself, and for good cause, but it ought to be a practicality now, a reasonable practicality that you fess up to what you do owe, if it is a good valid promise, but in good faith I think we have got to figure out now, if we do that, how to do it, and I think the first question is should the Federal Government get involved at all. We are not now involved, except letting you expense it.

Mr. VAN REMORTEL. Mr. Chairman, I read a book not too long ago written by a gentleman by the name of Odie Anderson, who wrote what I guess to this day is the definitive book on the history of health care, particularly corporately sponsored health care.

Immediately after the Second World War, when wages were frozen and prices were frozen, employers were looking for ways to provide additional compensation, and that was tough to do, with everything frozen. What the Federal Government did, to put corporate America into the health care business immediately after the war, was to provide a tax deduction for corporately sponsored, employer-sponsored health care, and that is when it began.

Now, it was not a big item in those days, a $5 trip to the doctor, a $14 a-night hospital stay. Now that it is a big problem and it is billions and billions and billions of dollars, I would like to suggest that we just cannot throw the problem back to corporate America. We got into it together and we have to work together to get out of it.

Chairman PICKLE. I don't think that is an unreasonable observation to make. I think the committee ought to keep those things in mind. I do not know that we put you into that business, but I do not think it is unfair to say we might have encouraged you to do it, because we let you write it off as an expense, and you have done it and you would I guess go along now and just expense it and never consider it a liability. But the question is, is it a liability or not?

Mr. VAN REMORTEL. In my opinion, it is very much a liability. And corporate America is not taking issue with the liability recognition as dramatically as a lot of the recent press would suggest. They are not taking issue with the Financial Accounting Standards Board. The Financial Accounting Standards Board's charter, as I understand it, is to make certain that corporate America makes full and complete disclosure of its financial affairs for the purposes

of the public and the shareholders, and I believe FASB is doing that and I believe the forthcoming mandate calling for balance sheet recognition and income statement recognition is consistent with their charter.

Chairman PICKLE. You would agree that if we go into the prefunding approach, that could have a definite effect on our Treasury?

Mr. VAN REMORTEL. It certainly will. But if we do not do that and we have big chunks of retiree America spending down and getting dumped into the Medicaid system, we would have the same situation.

Chairman PICKLE. Well, let me just pose a hypothetical question to you. Let us assume that Congress grants tax incentives to the pre-fund retiree health program, that is, the benefits. Do you think, either as a representative of your company or as an individual, that it would be appropriate to tax those benefits as part of the retiree's income when those benefits are received?

Mr. VAN REMORTEL. I think we would have to break the retirees into categories. Existing retirees, those people who are already retired, you could not make that kind of a change with. They are in retirement, they cannot at that point begin to redo their financial planning.

For persons within 5 or 10 years of retirement, I think the situation is the same. If we are going to change the nature of benefits and make them taxable to employees—let us pick a number arbitrarily—age 45 or 50 on down, so that it becomes part of their planning for retirement, then I guess that is certainly an option that could be considered.

Chairman PICKLE. It is an interesting problem for us, is it not?

Mr. VAN REMORTEL. Yes, it is.

Chairman PICKLE. All right. Well, I thank you gentlemen very much. I wish we had more time for more questions, but we will be submitting to you individually questions which we hope you would respond to here this fall.

Mr. VAN REMORTEL. Thank you.

Mr. MIKKELSEN. Thank you.

Chairman PICKLE. The next panel consists of Lawrence Cavanaugh, director of employee benefits for United Technologies Corp., representing the National Association of Manufacturers; and Thomas McMahon, vice president of administration and finance, Pacific Maritime Association, representing the Financial Executives Institute.

We will receive testimony first from Mr. Cavanaugh.

Mr. Cavanaugh.

STATEMENT OF LAWRENCE A. CAVANAUGH, DIRECTOR, EMPLOYEE BENEFITS, UNITED TECHNOLOGIES CORP., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY EDWIN GILROY, ASSOCIATE DIRECTOR OF EMPLOYEE BENEFITS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. CAVANAUGH. Mr. Chairman and members of the House Ways and Means Committee on Oversight, I am Lawrence Cavanaugh, director of employee benefits for United Technologies Corp. I am ap-

pearing here today in my capacity as a member of the National Association of Manufacturers' Employee Benefits Committee.

Accompanying me is Edwin Gilroy, NAM's associate director of employee benefits. I ask that my written testimony be included as part of my testimony.

Chairman PICKLE. Without objection, it is so ordered.

Mr. CAVANAUGH. Employee health care is quickly emerging as an issue of great importance in this country. Under proposed accounting rules of the Financial Accounting Standards Boards, the employers will soon be required to reflect on their corporate balance sheets the liabilities attributable to retiree health benefits.

Given the high cost of retiree health care and a rapidly increasing retiree population, the new FASB rules will adversely affect many companies, some severely. As a result, some employers will be forced to consider reducing or eliminating those benefits for future retirees. The NAM and myself considers this to be undesirable to both the employees and the employers.

Unfortunately, current law does not provide an adequate solution to this problem. In fact, recent legislation changes have restricted the few means available to employers for funding these benefits, thereby exacerbating the problem.

In addition, recent legislative and regulatory trends seem to undermine the longstanding policy that employee benefits are offered at the discretion of the employer. The NAM supports the notion that retirement security should reflect a partnership between the employee, the employer and the government. However, we do not support legislation that mandates these benefits without regard to the economic conditions that are unique to each industry and even companies within a particular industry. Such legislation, particularly when coupled with the proposed FASB rules, will prove, I believe, detrimental to American business.

The NAM supports legislation that would facilitate prefunding of retiree health benefits on a tax-favored basis. This includes tax-deductible employer contribution and the use of surplus pension assets. Such vehicles are critical if employers are to continue to offer these benefits and also contend with the new FASB regulations.

Now, while I have not reviewed the bill that is to be submitted today by Congressman Chandler, I did review a draft proposed in July. I think it was noteworthy primarily because it attempted to address the retiree health care issue in the context of retirement policy. This kind of legislation, we believe, is desirable. However, it should not impede employer flexibility by imposing unrealistic caps on pretax contributions, by imposing penalties on surplus pension assets or imposing excessive restrictions on lump sum distributions or in-service withdrawals from savings or thrift plans.

The NAM recognizes the responsibility employers share in providing adequate retirement security. As such, Congress is urged to fashion legislation which encourages employers to provide retiree benefits. Such legislation, however, should not restrict an employer's flexibility with regard to the design, the funding, or administration of these plans.

Thank you, Mr. Chairman, for allowing me the opportunity to testify on behalf of the National Association of Manufacturers.

[The statement of Mr. Cavanaugh follows:]

Testimony of
Lawrence A. Cavanaugh
Director, Employee Benefits
United Technologies Corporation
on behalf of
The National Association of Manufacturers
on
Retiree Health Insurance
before the
Subcommittee on Oversight
Ways and Means Committee
U.S. House of Representatives
September 15, 1988

Mr. Chairman, and Members of the House Ways and Means Subcomittee on Oversight, I am Lawrence Cavanaugh, Director of Employee Benefits for United Technologies Corporation, appearing today in my capacity as a member of the National Association of Manufacturers' Employee Benefits Committee. Accompanying me is Edwin Gilroy, NAM's Associate Director of Employee Benefits.

The NAM commends you, Mr. Chairman and members of the Oversight Subcommittee, for holding this hearing and providing witnesses the opportunity to discuss the critical issue of retiree health. This subject is of a great interest to the NAM, both in terms of its impact on our member companies and in its relationship to the national health and retirement policies that affect this nation's workers. For these reasons, the NAM feels this issue merits serious consideration and effective action.

The Changing Environment of Retiree Health Benefits

Retiree health benefits first appeared in corporate benefit plans during the mid-1960s as a supplement to the government-sponsored Medicare program. By 1986, 76 percent of full-time health plan participants in medium and large firms had coverage continued after early retirement; 90 percent after age 65. The retiree health concept, therefore, is not a new one, nor is the concern over the means available to employers to pay for these benefits. Much has happened of late, however, to heighten public interest in this issue and, in fact, to threaten the very nature and security of these benefits.

FASB. Proposed accounting rules to be issued by the Financial Accounting Standards Board will soon require employers to reflect on corporate balance sheets the unfunded liabilities attributable to retiree health benefits. Although questions remain regarding the administrative burdens presented by this formidable task, one notion appears unshakable: The financial implications of the new FASB rules will be staggering for many companies.

Estimates of the unfunded liability attributable to retiree health benefits range from the Department of Labor's conservative figure of $98 billion to the nearly $2 trillion reported by the House Select Committee on Aging. These figures alone are alarming. Of greater importance, however, is the potential impact these figures could have on corporate ledgers. The Employee Benefits Research Institute has reported that under the proposed FASB rules, the median Fortune 500 company could realize a reduction in net income of 30 to 60 percent. Given that impact, it is not unreasonable to assume that a company's entire business operation could be adversely affected as revenues and profit, credit ratings and operating costs are all negatively impacted.

Health Costs and Demographics. In the past, companies could easily meet retiree health obligations because medical costs were lower and retirees represented a relatively small portion of the employee population receiving benefits. With medical inflation nearing twenty percent, corporate health costs are no longer as easily managed. Other related factors -- changes in health care utilization and delivery, discoveries in medical science and increased longevity -- all have their impact on health care costs. Further, shifts in Medicare benefits, which place greater burdens on employers, could substantially increase corporate liabilities.

In addition, America's baby boomers are quickly coming of age and the percentage of retirees is growing. Studies show that the current ratio of workers to retirees at the average U.S. company is about 3 to 1. By the year 2000, that ratio is expected to drop to about 2 to 1. Since an aging population obviously means more retirees to care for, this demographic trend will only exacerbate the funding problems associated with providing health benefits to the elderly.

Judicial Developments. With alarming frequency, the courts have ruled that employers can no longer terminate or modify certain retirement benefits, regardless of the circumstances that may warrant such actions. In such cases as Eardman v. Bethlehem Steel, Hansen v. White Farm Equipment Co., Musto v. American General Corp. and Thonen v. McNeil-Akron, the options to curb or eliminate benefits for current retirees have been restricted. Perhaps the most notable of these rulings involved LTV Corporation's attempt to terminate its retiree health plan as part of its bankruptcy proceedings. Suit was filed on behalf of retirees and the subsequent court decision restricted an employer's right to unilaterally terminate retiree health benefits in connection with bankruptcy. In direct response to the LTV situation, Congress passed the Retiree Benefits Bankruptcy Protection Act of 1988, which prevents companies from terminating retiree benefits upon entering bankruptcy.

Legislative/Regulatory Restrictions
The NAM is concerned with legislative and regulatory trends that seemingly undermine long-standing public policy that holds that all employee benefits are offered voluntarily and at the discretion of the employer. Due to restrictive and costly provisions and the failure to recognize the diverse needs of employees, benefit mandates of any kind are ill-conceived. When viewed in conjunction with the proposed FASB requirements regarding retiree health, however, such mandates could become critical to a company's survival.

We are also concerned that federal legislation to date has failed to respond to the tremendous financial impact expected from the proposed FASB rules. Certainly, change of this magnitude demands public policy which recognizes the implications of that change and attempts to address these accordingly.

NAM strongly supports the notion that retirement security for American workers should reflect a partnership between the individual, government and employers. The fact that employers have offered retiree health benefits for over twenty years supports this argument. We strongly believe, however, that decisions regarding the design and funding of such benefits should not be mandated by Congress or the courts, but instead be left to individual employers who are best able to determine the needs of their employees and their companies.

In light of the upcoming FASB changes and recent court rulings, it is clear why the issue of retiree health has received so much recent attention. Employers will soon be faced with a difficult decision; specifically, how to continue to provide retiree health benefits while at the same time reduce the financial liability associated with those benefits. Unfortunately, current law does not provide a ready answer to this question. In fact, recent changes in the tax code have only complicated the problem. The Deficit Reduction and Fiscal Responsibility Act of 1985 and the Tax Reform Act of 1986 severely restricted the few means available to employers to prefund retiree health benefits on any kind of tax-favored basis. Ironically, this revenue-driven legislation was being drafted concurrently with the public's emerging recognition of the scope of the retiree health issue.

Recent changes to Medicare have also placed additional burdens on employers. Under the Tax Equity and Fiscal Responsibility Act of 1982, employers with 20 or more employees are required to be primary payers for certain workers over 65 with Medicare serving as secondary payer. Subsequent laws in 1984 and 1986 expanded this requirement to include all workers and dependents 65 and older.

In response to this changing environment, employers have been forced to consider alternative methods of reducing the burgeoning liability associated with retiree health plans. Among these alternatives -- cost management devices, use of Preferred Provider Organizations, and other design innovations -- have proven effective but are limited. More common is the growing tendency of employers to cut back on retiree benefits (to the extent the courts will allow) or to increase the cost to retirees of receiving these benefits. Less common, but of equal concern, are employer decisions not to offer retiree health benefits of any kind. Granted, the courts have held that an employer cannot unilaterally terminate an existing plan for current retirees. There is no law or precedent, however, that requires an employer to offer such a plan for future retirees. Given the lack of fiscal or legislative incentives, more employers are likely to consider this option in the future. The NAM believes this is unfortunate since most employers would prefer to offer these benefits, rather than be forced to reduce or eliminate them due to economic realities.

United Techologies has assessed how the proposed FASB rules would affect our benefits plan. To avoid the FASB impact, new retiree health programs at UTC will typically be employee pay-all, unless effective funding mechanisms are available. We are currently studying methods whereby both the company and employees may contribute to a funding vehicle to assist retirees in making premium payments.

Toward Improved Health Benefit Security

The NAM recognizes the responsibility employers share in providing adequate retirement security for workers. To that end, the NAM supports the voluntary establishment of retiree benefits, including both pension and health and welfare plans. Such plans ultimately are good for both employees and employers, and thus should be encouraged by Congress. Unfortunately, recent benefits legislation has been guided by revenue considerations, resulting in the emerging retiree health care crisis.

This is not to suggest that Congress has ignored the factors that have contributed to this crisis. We appreciate your efforts, Mr. Chairman, and those of other members in both the House and the Senate to address this issue. As such, we are particularly interested in the proposal submitted by Congressman Chandler (R-WA) and feel it merits comment here.

The NAM believes that Congressman Chandler's proposal is noteworthy primarily because it attempts to address the issue of retiree health within the context of the existing retirement system. This is a positive step toward a national policy that recognizes the inherent relationship between health care, retirement and long-term care considerations. We believe this is a solid foundation on which to build, and it appears that Rep. Chandler has begun that process. For instance, provisions for pretax funding of retiree health premiums, expanded pension coverage and repeal of the new full funding limits would all suggest a comprehesive policy that recognizes the need for sound funding over the lifetime of these long term commitments.

However, while the Chandler initiative clearly reflects an understanding of retiree health and its problems, certain items concern us. Unrealistic caps on retiree health contributions, restrictions and penalties for surplus pension assets, and excessive restrictions on lump sum distibutions, among other things, threaten to negate the many advantages to be gained by its other provisions.

In short, the NAM supports the principles upon which Congressman Chandler has based his proposal. We must stress, however, that this or any other proposal in this area should not achieve its goals at the expense of employer flexibility. Employers must be allowed to respond to the changing conditions that are unique to each industry. The same must hold true for corporate benefit plans. To do otherwise, be it through legislative mandates or excessive regulations, will ultimately do more harm than good.

CONCLUSION

The NAM shares the concerns of this Subcommittee regarding the issue of retiree health. Due to its far-reaching implications, any congressional action in this area will likely have a significant and lasting impact on employees and employers alike. Despite the challenges this presents, the NAM considers this a tremendous opportunity. As such, we urge Congress to use this opportunity to move forward in the area of retiree health specifically and employee benefits in general. The proposals offered by Congressman Chandler and others, as well as the efforts of this Subcommittee, are clearly a step in that direction. We applaud you and encourage you to continue. We also welcome the opportunity to work with you in this endeavor.

Chairman PICKLE. Thank you, Mr. Cavanaugh.
Now, Mr. McMahon.

STATEMENT OF THOMAS M. McMAHON, VICE PRESIDENT OF ADMINISTRATION AND FINANCE, PACIFIC MARITIME ASSOCIATION ON BEHALF OF FINANCIAL EXECUTIVES INSTITUTE

Mr. MCMAHON. Thank you, Mr. Chairman.

My name is Tom McMahon and I am the vice president of administration and finance for Pacific Maritime Association. I am here today as a representative of the Financial Executives Institute's Committee on Employee Benefits. The Committee on Employee Benefits is the technical committee for FEI which addresses all employee benefit issues.

At this point, I would like to do away with my prepared remarks and, as a fellow Texan, just speak to you directly and try to answer some of the questions you have been asking today. I do not think these Yankees can hear you. [Laughter.]

First of all, I have got some news for you, and I do not know if it is good news or bad news, but the vested liability for corporate America is not $2 trillion, it is not $400 billion, and it is not $200 billion. It is closer to zero, and the important word there is——

Chairman PICKLE. It is closer to what?

Mr. MCMAHON. It is closer to zero, and the important word there is "vested." Companies can walk away from these benefits and they have. I will give you an example: LTV, through the bankruptcy courts, did it. International Paper last year said all retirees after 12-31-87 are not going to receive retiree benefits any more. I will give you another example, the U.S. military walked away from it. If you are a retired military person, at 65 you go on Medicare. If you are a retired military person, the day you retire, the primary carrier is no longer the military, it is your spouse if they have a plan, or you if you have a plan.

Chairman PICKLE. Why are they walking away from the plan now?

Mr. MCMAHON. It costs too much. I will give you an example: It is new medicine. You go back to Forbes 400 and they take the cost of inflation for rich people, and you take a look at a facelift and they cost the same today as they did 25 years ago. But all the new medicine, CATSCANS and things like that, things that we didn't promise 25 years ago, are there today and we are continuing to provide those new medicine benefits. It has extended life, but it is very expensive.

Chairman PICKLE. Well, you say the companies—and you gave me three examples or more, where they have cancelled their health retirement plans?

Mr. MCMAHON. That is right, and there are going to be more, and I will tell you why.

Chairman PICKLE. And the reason they have done it is because of the cost that is involved?

Mr. MCMAHON. Well, there are other reasons. Let me give you an example: There is the rising health care cost, FASB is going to put a tremendous load on their balance sheet and they do not want to leverage their balance sheet. LBO's, unfriendly——

Chairman PICKLE. Do you mean you object to the fact that you would publicly admit what your liabilities would be in this field?

Mr. MCMAHON. There are no vested liabilities. There is not——

Chairman PICKLE. FASB and EBI have testified that it is a liability——

Mr. MCMAHON. They said a liability, but it is not vested, and those people have made a promise——

Chairman PICKLE. No.

Mr. MCMAHON. We as a committee want to keep those promises, but we need help from Congress in doing it.

Chairman PICKLE. Well, you are saying you want to keep them if we pre-fund them. Now, we did not get into any agreement with you 20 years ago that we were going to sponsor these programs, if later it got too costly we were going to let you then pre-fund it through tax credits. We did not have any agreement. You started those programs——

Mr. MCMAHON. That is true.

Chairman PICKLE. It was good policy and it has been good for the employees that benefit, too. Now the costs have increased, I think this committee must recognize that, and I think that we will. Now the question is how are we going to pay for them. All at once you said we will continue these things if you will give us a tax credit. Now, the question is should we get into it at all. You got into it, not us.

Mr. MCMAHON. OK. Let me say this, that 25 years ago or when the Studebaker case came out in the late sixties and they had not funded their pension plan, we came up with ERISA, we came up with a pension solution, we came up with requirements and they said we will do this for you if you will do this for them.

Now we have overfunded pensions, we have done our job, we have kept our promise to our employees on the pension side. Do you think there would be as many pensioners today if we had not had help from you? I am asking three things, two of which will provide more money to the Treasury.

The first one is, there is about $200 billion of excess pension assets and it would cost us about $5 billion a year to provide pension benefits to our retirees. Why not let us use that money? And if we do that, it is going to provide extra revenue to the Government. That is one thing, and——

Chairman PICKLE. Well, the committee has not made any decision of whether we are going to let you use those excess funds. We have protected you in the right that you can cancel a program and get that money. We have not taken that from you. That is still there. There is a big strong movement afoot to keep you from being able to do that——

Mr. MCMAHON. That is right.

Chairman PICKLE [continuing]. And, of course, you would like to use that excess money, but there is a legitimate question still prevailing unanswered, whose money is that. The law has allowed these and we do not know now what will happen to those funds if we do not allow the transfers of the funds, that is, the excess assets.

That is an unanswered question, that is a big question, but in the pension area I think the Congress did act responsibly in trying to

say that a lot of these funds were underfunded and we required that they now be funded, and I think that was a great improvement. But at the same time, that does not mean that we automatically are going to give you the right to use those funds forever or to give you prepayment. I want to pass judgment on it.

But it seems you and Mr. Cavanaugh both are saying these are enormous costs now that have grown and we will continue it only if you let us write it off as expense and only if you let us transfer assets if we the Congress let you do it. I would just say wait just a minute, I think we had better look at this a little bit more, and I think that is what this committee is going to do.

Now, I do not want to be arguing with you, but if you say you want to straight-talk like a Texan, I am trying to do that also.

Mr. MCMAHON. I can understand now. [Laughter.]

Chairman PICKLE. Go ahead.

Mr. MCMAHON. Well——

Chairman PICKLE. And I want to repeat that I am not attempting to pass judgment on how we ought to proceed or what we ought not to allow. I think everything is open for consideration. But I do not think that business in America ought to think that automatically this committee is going to say, well, these things need to be funded, therefore we are going to give you a tax credit, we are going to let you use these excess pension funds. I do not know that we are going to do that. We have other questions to be answered first. I do not think we ought to rule it out, and that is why we have had some legislation, and really that is why that is an enormous problem for us.

Mr. Chandler, do you want to make a statement on this?

Mr. CHANDLER. Not a statement, of followup on the comments of Mr. McMahon with some questions. Now, regarding the $200 billion in surplus assets that are available, what option do employers, who have those assets in their pension plans, have for those assets right now? What can they do?

Mr. MCMAHON. Well, right now there is, the sense of the Senate's proposal to impose a 60 percent excise tax on them, so there is very little that we could do, I don't think anyone would want to do it unless they wanted to cut their nose off to spite their face.

You know, our committee does not particularly love your bill, Congressman Chandler. There are some things that we disagree with in it. But we would be willing, on a tradeoff basis—you know, one of the things that you want is 100 percent excise tax and let you use the money to fund retiree benefits, and that is something that we have deliberated over long and hard and finally come to an agreement as a committee that we would support that, and that we feel is a significant thing on the part of the business community, to come up here and say we will only use that money for one thing, we will not use it to fund general business purposes but just to take care of our retirees, and, I may add, to keep the promises made to our employees.

Mr. CHANDLER. But if business were to utilize those funds for something other than retirement benefits, they would have to terminate the pension plan under current law.

Mr. MCMAHON. That is correct.

Mr. CHANDLER. That is the only way the business could gain access to those funds, which is——

Chairman PICKLE. I do not think I would disagree that that might happen in many instances.

Mr. MCMAHON. I would hope not.

Chairman PICKLE. You have got that right.

Mr. CHANDLER The point which I believe needs to be made here is that businesses or even their employees really are not in a position to use those funds for anything other than the purposes intended right now. Something which I believe is very destructive is a policy which influences them toward terminating a pension plan if they want to gain access to those funds. That is a policy which just seems totally at cross purposes with what we are trying to accomplish, whether we decide to let them use these funds to prefund a retiree health plan or not. But the thing that I believe I heard you say was, and Mr. Ostuw earlier, that one of the options open to businesses now for current workers, even though they have been promised a retiree health benefit, is they can terminate any time they want and eliminate that liability, unless there is a bargaining agreement or something similar.

Mr. MCMAHON. Well, even with the bargaining agreement with the unions, most of them, the contracts say that not only current employees but retirees that are covered by the contract, it only goes for the life of the union contract and once that contract ends, there is no guarantee to the union members. So, there are a lot of people, if it starts, it is going to be widespread, I believe.

Mr. CHANDLER. Mr. Cavanaugh, I believe you said, then, if someone felt, "Well, boy, we will show them," on the other side of it, that we could really jeopardize the very existence, let alone the health of some companies in the United States, if we mandated a pre-funding or the continuation of a benefit.

Mr. CAVANAUGH. What I was really referring to is: the FASB liabilities going on the books of corporations are going to have a devastating effect on some companies. The prefunding of the liabilities, I am suggesting, is something that will enhance the longevity of retiree health benefits.

Mr. CHANDLER. But did you not object to a mandated program? Was that not your point?

Mr. CAVANAUGH. The mandation that I object to or that the National Association of Manufacturers is objecting to is where the benefit level or structure is being mandated, not the mandate that you can fund. I am not quite sure——

Mr. CHANDLER. No, I understand that. OK. That is the point I was trying to make.

Mr. CAVANAUGH. I am not sure how the funding would be accomplished, because of the interest assumptions and the inflation assumptions that have been used.

Chairman PICKLE. Would you yield?

Mr. CHANDLER. Surely.

Chairman PICKLE. I assume you are saying that, yes, we think these retiree plans are good and ought to be continued some way or another——

Mr. CAVANAUGH. Absolutely.

Chairman PICKLE [continuing]. But you do not want to be mandated and say you have got to pay for them?

Mr. CAVANAUGH. If they are continued, obviously the employer is going to pay for them. What we do not want is the mandates as to the type of benefits or a mandate that says that you will have to have a retiree benefit.

Chairman PICKLE. I understand.

Mr. CHANDLER. Those are all the questions I have, Mr. Chairman.

Chairman PICKLE. All right. Thank you. We will also submit some questions for you.

[The statement of Mr. McMahon follows:]

STATEMENT OF THOMAS M. McMAHON, FINANCIAL EXECUTIVES INSTITUTE

My name is Tom McMahon and I am the Vice President of Administration and Finance for Pacific Maritime Association. I am here today as a representative of the Financial Executives Institute's Committee on Employee Benefits. The Committee on Employee Benefits is the technical committee for FEI which addresses all employee benefit issues. The Committee is comprised of financial officers and plan administrators representing a broad cross-section of major U. S. employers, who are responsible for the development, implementation and management of pension, welfare and other post-retirement benefits. FEI is a professional association of 13,000 financial executives representing over 6,000 companies based in the United States and Canada.

I appreciate the opportunity to address the Committee on Ways and Means' Oversight Subcommittee. I commend Congressmen Pickle and Chandler for the foresight and leadership they have shown by recognizing that the future of retirement health care in America is a crucial issue which affects our government, our employees and our nation's companies.

Employer provided retiree health care is at a crossroads. I will elaborate on four major factors, which I believe have placed retiree health care benefits in such a precarious position. The four factors that are and will continue to affect retiree medical care are:

1. Escalating health care costs;
2. The Financial Accounting Standard Board's proposal for accounting for post-retirement benefits other than pensions;
3. Corporate Raiders and leveraged buy-outs (L.B.O.); and
4. Government compliance requirements.

By discussing each issue separately, I hope you will be able to see that any one of the four could jeopardize coverage; moreover, the cumulative effect of two, three or four of these issues could almost certainly mean the curtailment of this type of coverage.

RISING COST OF COVERAGE

Clearly, the most obvious and well-discussed of the four issues is the escalation of health care costs. Despite attempts at controlling medical costs they are still escalating in the private sector at 15% to 20% per year. The retiree component of these costs is rising even faster. Nearly eleven percent of our nation's G.N.P. is spent on medical care and approximately one-half of that is spent on individuals in their last year of life. New medical advances have no doubt prolonged our average life, but they are expensive. At the same time that these costs are increasing, the amount paid by medicare for retirees as a percent of the total is decreasing. This is forcing corporations or retirees to pay an ever expanding percentage of the increased costs of retiree health care.

In answer to the question "has anyone ceased coverage for retirees as a result of these increased costs", the answer for one is the U. S. Military. In reviewing the increased costs of providing medical benefits to military retirees, the powers that be mandated that the military would not provide coverage to any

retiree who was provided coverage by a private plan even if it was the spouse's plan. Furthermore, upon reaching 65, the entire cost of military retiree health care is pushed upon medicare.

If rising costs forced the military to do this to its retirees, private employers will also be forced to look at termination of retiree benefits as a viable alternative to controlling medical costs.

FASB STATEMENT ON ACCOUNTING FOR POST RETIREMENT BENEFITS OTHER THAN PENSIONS.

The FASB has done a measure of good by forcing corporate America to recognize the tremendous unfunded promise we have made to our present and future retirees: Current projections exceed two trillion dollars. Unfortunately, the method by which they propose to account for this issue is tantamount to throwing the baby out with the bathwater. While FASB officials recoil in horror when they admit that many organizations state that the FASB proposal "is forcing employers to choose between reducing or eliminating these (retiree medical) benefits and facing financial ruin." They have defended an accrual method of accounting that "vests for accounting purposes" a retiree medical benefit at age 55. In truth, very few if any retirees are legally entitled to a benefit until the very day they retire. This method of accounting will force many companies to report retiree medical expense at a rate equal to five times as much as they are currently reporting. For some currently profitable companies, this measure will put them into a loss position and in addition it will lever their balance sheets at a time they least can afford it.

In anticipation of the FASB pronouncement, several companies have either ceased providing retiree medical benefits or are planning to do so. One Fortune 500 company announced in mid-1987 that any employee that retired after December 31, 1987 would not receive company paid retiree medical coverage. In my opinion, more companies will be forced to follow suit.

CORPORATE RAIDERS AND L.B.O.'s

At a time when there is heightened pressure upon chief executives of publicly traded companies to manage their companies with an eye to maximizing short-term results, any increase in expense similar to the ones mentioned above are to be avoided like the plague. One bad quarter of reported performance, with a resultant stock decline, can put a company in play. Once the raider has control or management has been forced into a balance sheet leveraging L.B.O., corporate emphasis shifts from long-term goals of providing a stable base of employees, research and development, enhancing quality control or developing brand loyalty to the ultimate short-term requirement of providing as much cash as possible to reduce a bloated debt load.

In addition to reduced capital expenditures, employee layoffs as well as salary reductions and reduced benefits for those employees that remain, retiree medical benefits will be one cash expense that will be considered for elimination in an unfriendly tender or L.B.O. In my opinion, however, the incentive that we suggest below, will, even in the case of an unfriendly Tender or L.B.O., reduce the likelihood of companies terminating or reducing retiree health care coverage.

GOVERNMENT COMPLIANCE

Within the last six years, we, as corporate benefit plan administrators, have been faced with one change after another in the administration of these plans.

These rules have been heavy handed at times. For instance the proposed penalties associated with COBRA noncompliance brought forth more complaints than any other similar legislation. Fortunately, the outcry lead to development and implantation of reasonable and appropriate sanctions against violations.

This year Section 89 adds to the burden. While the objective of this legislation is worthwhile, i.e., to broaden the base of employees (and retirees) receiving medical coverage, the means do not justify the end. The test is comprised of four parts that are so complicated and interwoven that few, if any, will be able to complete this maze without the aid of a consultant. The ultimate result of these tests will not be increased coverage, but increased taxation of the middle class with the inclusion in taxable earnings of any benefits paid to those people who earn as little as $50,000.00 a year.

A final example of legislative compliance that appears onerous to business is contained within the Medicare Catastrophic Coverage Act. While this bill is well intentioned and provides needed coverage for those elderly individuals who may be faced with literally making a choice between living and dying, the people who drafted the bill in effect have penalized responsible companies that are providing retiree coverage. Those companies will not be able to recognize any cost savings from this Act. In fact, these employers would have to pay to their current retirees any savings that resulted from Medicare picking up these costs. They would also have to determine what the "actuarial equivalent" of these benefits are and reimburse the retirees for them. Of course, no one has yet determined what the actuarial equivalency of any benefit is, but we as administrators still have to try to define it and implement it correctly or be faced with a Civil Liability.

As you can see from the above, there are many obstacles facing us as administrators in our efforts to continue to provide post-retirement medical coverage. But, I can say clearly that if Congress can work with us, corporate America will be willing and able to respond to the challenges before us.

What are the incentives needed? I will outline a legislative program we would like to see enacted. The first incentive would be to permit companies to pay their current retiree health benefits directly from excess pension assets. The second incentive would permit companies to transfer a portion of such excess pension assets to a separate fund which would pay retiree health benefits for current and future retirees. Finally, the third incentive would be the establishment of the same type of ongoing tax-favored funding for retiree health care as we already have for pensions.

The details of this approach are as follows: First, let's permit companies to pay their current retiree health benefits directly from excess pension assets in their pension funds, rather than from general corporate funds.

This proposal would increase tax revenues by $500 million to $1 billion annually. This would occur because payments of

retiree health benefits from excess pension assets would not be tax deductible -- while current payments on a pay-as-you-go basis from general corporate funds are tax deductible. Moreover, the proposal would make retiree health care promises more secure for retirees without jeopardizing the security of their pension promises. Excess pension assets are now estimated at over $200 billion versus an annual corporate pay-out for retiree health care of only $5 billion. Thus, a cushion could easily be retained in pension plans to insure further protection for pension promises.

Our second proposed legislative step would be to allow employers whose pension plans are overfunded to transfer a portion of the excess assets to a separate fund which would pay retiree health benefits for current and future retirees. This would be another move in the direction of eventually permitting full advance funding of retiree health benefits and increasing tax revenues. Payments from a retiree health care fund would not be tax deductible -- while current payments on a pay-as-you-go basis from general corporate funds are tax deductible. Finally, this step would also make retiree health care promises more secure for retirees without jeopardizing the security of their pension promises because the rules should leave a cushion in the pension fund.

As stated earlier, excess pension assets are now estimated at over $200 billion. An aggregate of funds in this amount should go a long way toward solving the problem -- thus minimizing corporate actions to reduce or eliminate retiree health care benefits.

This brings us to our third and final proposed legislative incentive which would be the establishment of the same type of ongoing funding vehicle for retiree health care as we already have for pensions. That is, the ongoing ability to prefund post retirement medical benefits on a tax-favored basis.

On behalf of the Committee on Employee Benefits, I commend you for the foresight you have shown in looking at the difficult and complex issue of retiree medical care. The Committee on Employee Benefits believes the three-pronged approach I have outlined is a strong beginning to address this most complicated issue. Introduction and passage of legislation along these lines would provide a clear signal to private employees that there is a recognition in Congress of these problems and that we as employers can work together to solve them. I thank you for the privilege of testifying before the Oversight Committee and look forward to working with you as we grapple with this worthwhile goal of providing retiree health care.

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Chairman PICKLE. We have got another panel and we have got another meeting at 4 and we have got to move along, but I would enjoy further exchange with you and we are going to have another hearing this fall and we are going to go into it again next year. It may be that we will be seeing each other again, so until we meet again——

Mr. CAVANAUGH. Let us hope so.

Chairman PICKLE. Now we will have a panel consisting of Mark Ugoretz, Edward Davey, and Michael Gulotta.

Mark Ugoretz is the executive director of ERISA Industries Committee; Mr. Davey is principal of the A. Foster Higgins Co., representing the Association of Private Pension and Welfare Plans; and Mr. Gulotta is president and chief actuary of the Actuarial Sciences Associates, Inc., representing the Coalition for Retirement Income Security.

We will proceed first with our friend, Mark Ugoretz, who has been before this committee before, either you or your valiant legislative assistant, Ms. Gregory. We are glad to have you and we will proceed with your testimony first.

STATEMENT OF MARK J. UGORETZ, EXECUTIVE DIRECTOR, THE ERISA INDUSTRY COMMITTEE

Mr. UGORETZ. Thank you, Mr. Chairman.

My name is Mark Ugoretz. I am executive director of the ERISA Industry Committee. We appreciate very much the opportunity to share our views with the members of the Oversight Committee on the subject of employer-sponsored retiree health benefits. These are important benefits to our members and to their employees who depend on them.

In the interest of time, I am going to summarize our written testimony.

Retiree health plans are offered as part of an employer's overall industrial relations program as a means of attracting and retaining productive long-term employees. These benefits are similar to the benefits received during active employment; after age 65 the benefits are supplemental to Medicare.

While employers are able to secure their pension plan liabilities by funding those liabilities, since 1984 they have no longer been able to fund the costs of retiree health coverage on a tax-favored basis by way of a dedicated trust. Funding retiree health benefits through such trusts provided employers with the continuing ability to offer retiree health benefits on a rational basis and sheltered the benefits from the exigencies of unpredictable business cycles.

We recognize that tax-deductible contributions are not likely to be restored in their pre-1984 form, nevertheless we believe that it is in the interest of both employees and employers, as well as sound social policy, to restore the means of funding postemployment health care coverage on a tax-favored basis. Such funding of retiree health coverage, however, should not be required of an employer merely because the company offers the benefit. In fact, there are some companies, depending on workforce demographics and other circumstances, where funding may not be cost-effective or even affordable.

In addition, some employers whose pension plan assets exceed their liabilities seek the ability to transfer a portion of those excess pension assets to a trust set up to fund retiree health benefits. We strongly support such voluntary asset transfers as a responsible and effective means of retiree health plan funding.

Employers are faced with several threats to the cost of their retiree health programs, including the new FASB accounting standards, mandated benefits, and the transfer of Medicare obligations to the private sector. The FASB accounting standard will require employers to account for and quantify their retiree health liabilities. Thus, under the new FASB standard, a company offering retiree health benefits will be faced with a catch 22: The company will be required to show its retiree health benefits as a liability on its corporate balance sheet, but will be effectively penalized for prefunding that liability.

Employers are also concerned about the ever-increasing tendency to impose new and costly mandated benefits in return for tax favored treatment of providing and funding health care coverage. We strongly oppose the imposition of such mandates which are costly, which limit flexibility, and which preclude employees from having a voice in fashioning the benefits they deem necessary for their own security.

In addition, employers are faced with continuing changes in the Federal law that transfer Medicare benefits and obligations to the private sector. Health care coverage for retirees and other nonemployed persons is a governmental obligation. Transferring that obligation to employers substantially increases employment costs.

Given the rapidly escalating costs of health care, there is already substantial pressure to reduce health care costs across the board, notwithstanding the FASB project for mandated benefits and Medicare cost sharing. These cost increases can substantially diminish a company's ability to offer competitive products and services in foreign as well as domestic markets, including markets in which the competition may have a younger workforce. As a result, many employers will be under tremendous pressure to control their liabilities by reducing or eliminating the retiree benefits they now offer. If such cost-cutting is not effective, employers will look to other means of reducing overall employment. That includes outsourcing of materials or services currently manufactured or produced in-house, or they may move plants elsewhere, including overseas. It is, therefore, critical that any legislative directives do not increase the costs of offering health care coverage for retirees or active employees.

We also appreciate very much the efforts of Representative Rod Chandler and Representative Ron Flippo who are introducing legislation concerning this issue, as well as other members in exploring other concrete approaches to retiree health funding.

We look forward to working with the committee in developing new approaches and in our own effort to come to grips with the retiree health funding issue. ERIC, the ERISA Industry Committee, has developed the following general principles more fully explained in other comments as a guide for our continuing consideration:

First, as I indicated earlier, we believe that Medicare should continue as the primary payer of health care for retirees over the age

of 65, with employers who choose to do so providing access to group plans for early retirees; second, employers and workers should be able to pre-fund retiree health care coverage; third, employers should retain the ability to alter health care coverage benefits; fourth, employers should be permitted but not required to use excess pension assets to fund retiree health care benefits; and, fifth, the Federal preemption of State health care requirements should be strengthened.

Mr. Chairman, we thank you very much for your attention and your continuing interest in this important issue.

[The statement of Mr. Ugoretz follows:]

STATEMENT OF THE ERISA INDUSTRY COMMITTEE
BEFORE
THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
SEPTEMBER 15, 1988

EMPLOYER SPONSORED RETIREE HEALTH INSURANCE

Mr Chairman, my name is Mark Ugoretz, I am Executive Director of The ERISA Industry Committee (ERIC). We appreciate the opportunity to share our views with the members of the Oversight Subcommittee this morning on the subject of employer sponsored retiree health benefits. These are important benefits to our members and to their employees who depend on them.

The ERISA Industry Committee represents the retirement security and employee benefits interests of over 100 of America's major industrial enterprises. ERIC's members provide and administer comprehensive retirement plans, health care coverage and other employee benefits for some 25 million active and retired workers and their families and beneficiaries in what is an extraordinarily successful voluntary system. Thus, we have a strong interest in proposals affecting retiree health plans and other employee benefits that provide important life security programs to tens of millions of workers and their families.

Many major employers, including members of The ERISA Industry Committee (ERIC), provide health care benefits to their employees during their retirement. Until retirees become eligible for Medicare, these benefits are generally similar, if not identical, to the health care coverage employees receive while employed. Retiree health plans are offered as part of an employer's overall industrial relations program as a means of attracting and retaining productive, long term employees. As the work force ages, more and more workers view these programs as increasingly important and as a reason to remain with an employer.

While employers are able to secure their pension plan liabilities by funding those liabilities, employers are no longer able to fund the cost of retiree health care coverage on a tax-favored basis. Prior to 1984, some employers had begun to use Voluntary Employee Benefit Associations (VEBAs), under Internal Revenue Code Section 501(c)(9), as a means of funding their retiree health obligations. Funding provided employers with the continuing ability to provide retiree health benefits on a rational basis and sheltered the benefit from the exigencies of unpredictable business cycles.

In 1984, however, Congress effectively abolished employers' ability to fund retiree health benefits through a tax-favored trust. Under current law, employers who offer retiree health care coverage generally pay for the benefit from current operating revenues, taking the tax deduction as a general business expense.

The Financial Accounting Standards Board (FASB) has indicated its intention to require companies who offer retiree health plans to account for those arrangements as a liability on corporate balance sheets. FASB's accounting standard is expected to be released in the latter part of 1988 as an "exposure draft" with a final standard anticipated in 1989.

The FASB accounting standard will require employers to quantify their retiree health liabilities.

Thus, under the new FASB standard, a company offering a retiree health benefit will be faced with a "Catch-22;" the company will be required to show its retiree health benefits as a liability on its corporate balance sheet but will be penalized for funding that liability.

In addition to the FASB standards, employers are faced with continuing changes in the federal law that transfer Medicare benefits and obligations to the private sector. Health care coverage for retirees and other nonemployed persons is a governmental obligation. Transferring that obligation to employers substantially increases employment costs. Such cost increases can substantially diminish a company's ability to offer competitive products and services in foreign as well as domestic markets, including markets in which the competition may have a younger workforce. As a result, many employers will be under tremendous pressure to reduce their liabilities by reducing or eliminating the retiree benefits they now offer.

Thus, companies might not offer the benefit to new hires, they may terminate or substantially restrict the benefits for active employees, or they may install substantial cost-sharing and co-pays for active and retired employees. Given the rapidly rising costs of health care, there is already substantial pressure to reduce health care costs across the board, notwithstanding the FASB project and Medicare cost shifting by the government.

If such cost-cutting is not effective, employers will look to other means of reducing overall employment costs. Thus, they will look to outside sources for materials or services currently manufactured or produced in-house, or they may move plants elsewhere, including overseas. These options, as well as other cuts in employment costs, would involve substantial reductions in jobs for American workers. <u>It is therefore critical that any legislative directives do not increase the costs of offering health care coverage for retirees or active employees</u>.

During the past several years, major employers have supported restoration of a trust arrangement to fund retiree health care coverage on a reasonable tax-favored basis. While we recognize that tax deductible VEBA contributions are not likely to be restored in their pre-1984 form, we believe that it is in the interest of both employees and employers, as well as sound social policy, to provide a means of funding the cost of post-employment health care coverage on a tax-favored basis. Moreover, such funding of retiree health coverage, should be allowed on a voluntary basis and should not be required of an employer merely because the company offers the benefit. For some companies, depending on workforce demographics and other circumstances, funding may not be cost-effective or even affordable.

In addition, some employers whose pension plans' assets exceed their liabilities seek the ability to transfer a portion of those excess assets to a trust set up to fund retiree health benefits. We strongly support such voluntary asset transfers as a responsible and effective means of retiree health plan funding.

We strongly oppose the imposition of current pension vesting rules, participation and coverage standards, and funding standards for retiree health plans. The standards and rules that have been imposed on pension plans simply cannot be applied to retiree health coverage. Pension benefits and health benefits are completely different and require different rules. If any vesting, participation, coverage, and other similar rules were deemed necessary, they would have to take into account the unique nature of the retiree health benefit.

Employers also are concerned about the ever increasing tendency to impose new and costly mandated benefits in return for tax-favored treatment of providing and funding retiree health care coverage. We would strongly oppose the imposition of such mandates which are costly, limit flexibility, and preclude employees from having a voice in fashioning the benefits they deem necessary for their own security.

We anticipate that this will be the first of several hearings in this and the 101st Congress as Members of Congress become more familiar with an issue which is as complex as it is important. Regardless of its complexity, however, the funding of retiree health benefits is by no means insoluble. It is an issue that must be resolved carefully, since Congress should not create an incentive for employers who offer the benefit to discontinue their current retiree health coverage nor a disincentive for other employers to provide it.

We appreciate the efforts of Representative Rod Chandler, who today introduced a bill concerning this issue, as well as other Members in exploring concrete approaches to retiree health funding. We look forward to working with the Committee in developing a new approach to funding retiree health liabilities.

The ERISA Industry Committee, like other organizations, Members of Congress and their staffs, and the Administration, has had the retiree health issue under active consideration and discussion for some time. For the purpose of our internal discussions, we have developed the following general principles as a guide for our continuing consideration.

First, Medicare should continue as the primary payor of health care for retirees over age 65, with employers who choose to do so providing access to group plans for early retirees.

The cost of providing health care to retirees is and should continue to be generally recognized foremost as a societal responsibility which should be spread across as large a base as possible. Employer-provided retiree benefits must be secondary to government benefits for which employer and employee are taxed. Changing the rules so as to make employer plans primary is a major disincentive to creation and continuation of any employer health plans, would significantly increase employment costs, would lead to requirements for new and increasingly specific mandated benefits, and would substantially weaken the ability of U.S. firms to compete in world markets.

Second, provision of benefits and funding for benefits should be both permissive and tax effective for both businesses and individuals.

Employers' ability to voluntarily fund retiree health benefits on a tax-favored basis ought to be restored. Participants should be able, but not required, to contribute to and withdraw assets from a separate trust on a tax-exempt basis to meet health care needs in excess of those provided for through employer arrangements.

Third, employers should retain the ability to alter health care benefits.

Health care coverage commitments (unlike pension commitments) are open-ended, that is, it is virtually impossible to forecast the cost of coverage, or, for that matter the actual coverage requirements themselves, for an employee some 20 to 30 years down the road. Thus, employers should retain the ability to structure benefits commensurate with the employer's ability to pay, the needs of employees, and competitive practice in the markets in which the company competes.

Employers must retain the flexibility to revise coverage justified by the changing cost of coverage, developments in health care delivery and science, and similar circumstances. Requirements that accompany tax-favored treatment of health plans should recognize the unique circumstances of health care coverage and not merely mimic the requirements imposed in pension plans (for example, vesting and benefit accrual).

Fourth, employers should be permitted, but not required, to use excess pension assets to fund retiree health care benefits without adverse tax consequences.

The voluntary use of excess pension assets would utilize for retiree health plans funds already available but not necessarily reserved or committed for employees. As a result, promised retiree health care benefits could be secured in many circumstances without jeopardizing retiree pensions.

Fifth, federal preemption of state law should be strengthened.

The cost of employee health care should not be further increased by requiring that employers doing business in many different states be unreasonably burdened with meeting the varying requirements of over 700 diverse state laws regarding health benefits providing for different coverage standards, benefits, and service provider mandates.

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Chairman PICKLE. All right, Mr. Ugoretz. Thank you.
Now, Mr. Davey.

STATEMENT OF EDWARD J. DAVEY, PRINCIPAL AND NATIONAL PRACTICE LEADER, A. FOREST HIGGINS CO., INC., ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. DAVEY. Thank you, Mr. Chairman.

My name is Ed Davey, and I am a principal with A. Forest Higgins, a wholly owned subsidiary of Johnson & Higgins. We are a national consulting firm. I am here representing the Association of Private Pension and Welfare Plans, an association that I used to be the executive director and general counsel. I had the opportunity to testify on an issue of VEBA here in 1984 that before this subcommittee.

In the interest of time, I would like to ask that my statement be submitted for the record and just raise a couple of points.

Chairman PICKLE. Without objection.

Mr. DAVEY. One, I think it is very important to understand that, although FASB is maintaining that this is strictly an accounting project, I think it is important for Congress to understand that the accounting issue here is driving national health policy. I think we have to ask the question, should national health policy be determined in the accounting arena or in the political arena. I think the issue should be debated in the political arena in institutions such as this committee or other appropriate bodies.

The issue here is not disclosure. We have disclosure. The question is what is the impact of bringing this liability up to the corporate financial statements, and what behavioral changes will that cause? Is this something that Congress wants to happen? I think that is the heart of the issue.

Second, I think any national health policy must look at who is going to pay for health coverage; the Government, employers, or the individual. Also you must look at a worker over his lifetime, I think there are four stages of health coverage.

The first stage, of course, is when the individual is an active employee. The second critical stage is when, if that employee so chooses, and we are seeing more of it, takes early retirement. The next stage, of course, would be at age 65 and some period beyond age 65, let us say 10 years. The fourth stage would be when the individual needs long-term care. And I would suggest to you, Mr. Chairman and members of the committee, that the relationship between the government, the employer and the individual, and their responsibilities in each one of those stages might vary considerably. Contributions and costs of providing health coverage will vary I think that is where we might focus.

The interesting point here is that, in early retirement, post-65 and long-term care, we are talking about the entire area of postemployment benefits, and I do not think we should be lumping policy in all those areas and saying that it should be treated the same.

For example, the employer's responsibility in the early retirement situation might be very different than post-65 or long-term care. These are some of the issues I think that we need to address.

Third, I think that a lot of people are saying that we can mirror the pension system. I think we must acknowledge that a health benefit and the way we deal with health benefits is very, very different than the way we deal with a pension benefit. I do not think you can necessarily mirror that system completely.

Companies treat health benefits very, very differently. In fact, one of the reasons that companies have not used 401(h) accounts or, for that matter, VEBA's prior to 1984, was the inability to control health costs the way they can control costs in a pension plan.

Finally, I think that it is important for Congress not to allow issues to get away from them in developing a national health policy. We have pending on the other side of the House a proposal for a 60 percent excise tax on reversions. Before we allow that, we might want to consider how those reversions might be used in dealing with this problem before we cut off that particular option.

The bottom line I am suggesting is that we need a comprehensive policy across the board on health coverage and not just looking at individual pockets.

Thank you very much for your time, sir.

[The statement of Mr. Davey follows:]

Statement
of the
Association of Private Pension and Welfare Plans (APPWP)
on
"Employer-Sponsored Retiree Health Insurance"
before the
Subcommittee on Oversight
of the
Committee on Ways and Means
September 15, 1988

Mr. Chairman and members of the Subcommittee, I am Edward J. Davey, Principal and National Practice Leader for the A. Foster Higgins Company, a national employee benefits consulting firm. I am appearing today on behalf of the Association of Private Pension and Welfare Plans (APPWP). I serve as the Chairman of the APPWP Post-Employment Benefits Committee. The APPWP is a non-profit organization founded in 1967 to promote the growth and health of our nation's private employer-sponsored pension and welfare-benefits system. We commend you for holding this hearing on the very important topic of post-employment health benefits and we appreciate the opportunity to testify.

SCOPE OF THE ISSUE

Continuation of health care benefits upon retirement has been an important and growing trend among medium and large companies in the two decades following the establishment of the Medicare system. In 1986, 76 percent of full-time health plan participants in medium and large companies had health coverage continued upon early retirement and for those retiring at age 65, the level rose to 90 percent.

During the early years in which employers provided retiree health benefits, Medicare paid for most retiree coverage and the employer-sponsored plans served a largely supplementary function. However, in recent years company costs have escalated as the population has aged, as medical inflation has soared and, in many mature industries, as the ratio of active employees to retirees has narrowed. Additionally, Congress, in an effort to curtail Medicare costs, increasingly has made employer plans, in effect, the primary payor of retiree health care expenditures.

Post-Employment health care benefits have increasingly become a major component of employee benefit programs and have come to command a large share of the financial resources for a great number of the nation's larger firms. A 1986 U.S. Department of Labor study estimated that benefits already promised to workers over the age of 40, represented $98 billion worth of liability. However, a subsequent report from the House of Representatives Select Committee on Aging placed the liabilities at closer to $2 trillion; a figure which most in the employee benefits field feel is closer to the actual total.

Now that the Financial Accounting Standards Board (FASB) has neared completion of its exposure draft proposal for requiring companies to reflect these liabilities directly on a company's balance sheet, corporate attention to post-employment health care liabilities will be even greater. The effect of FASB's proposals on many companies in terms of their financial status and, in turn, on their stock values will be extraordinary. The Employee Benefit Research Institute has reported that if FASB were to adopt requirements based upon the same rules applicable to pension plans, many firms would be faced with an additional per employee expense of $1200 to $2400. This represents a 30% to 60 per cent reduction in net income for the median Fortune 500 company.

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Although the FASB has consistently maintained that its project is intended only as standard for accounting, Congress must recognize that the requirement to include retiree health liabilities on corporate financial statements, which almost certainly will be required by the FASB, will most severely impact national health care policy and the ability of the private sector to voluntarily assume its role in providing health care coverage for America's aging population. For example, one large employer has estimated that the likely new rules will increase the current liability shown on its income statements by more than three times and will force recognition of hundreds of millions of dollars on the company's balance sheet. The attention of Congress to this important policy debate could not occur at a more important moment.

OBSTACLES TO FUNDING RETIREE HEALTH BENEFITS

At the same time that U.S. employers have been making promises to current and future retirees to provide valuable post-employment health benefits, the companies' ability to appropriately set-aside funds to meet those obligations has been diminished severely. Employers' principal vehicles for advance funding of accruing liabilities for post-employment health benefits are IRC Section 501(c)(9) trusts, known as voluntary employee benefit associations, or " VEBAs," and trusts established pursuant to IRC Section 401(h).

The Deficit Reduction Act of 1984 (DEFRA) dramatically restricted the use of VEBAs for funding post-employment health coverage by limiting deductions to the extent justified by current plan costs. Earnings on funds in a VEBA for financing post-employment health benefits are taxable as unrelated business income tax. The 401(h) trusts also have limited applicability because funding for post-employment health benefits is capped at 25 percent of the employer's current pension plan contribution. This restriction essentially prohibits pre-funding of unfunded retiree health care liabilities.

The employer community in general, and the APPWP in particular, is sensitive to the budgetary considerations accompanying proposals to reverse the current severe restrictions on pre-funding of these benefits. At the same time, we urge this Committee to consider the financial implications for the federal Treasury if private employers are not able to provide for retiree health benefits and, instead, the nation's retired population looks to public programs to alone serve as guarantor of their health care financial needs. Congress has gradually shifted more retiree health care costs to employers to ease the financial burden on Medicare. If employers are to respond to post-employment health care needs, including the mounting concern over long-term care, employers will need -- and frankly deserve -- deductibility for pre-funding these obligations. In the absence of these tax code revisions, and faced with the financial implications of the FASB requirements, employers will have little choice but to limit their promises to future retirees to the extent the law or contractual obligations permit.

"ERISAFICATION" OF RETIREE HEALTH BENEFITS

Clearly, employers who voluntarily provide post-employment benefits should continue to be required to disclose the terms and nature of the benefits to be provided. But, inevitably, discussion of pre-funding post-employment benefits leads to proposals to apply many of the same standards of the Employee Retirement Income Security Act (ERISA) that now regulate pension plans, to health plans as well. Such standards include proposals to vest employees and retirees in health care plans on the same basis as they are vested in pension arrangements. While employers are certainly open to discussions of greater protections for employees/retiree under health care plans, it is absolutely essential that certain fundamental differences between pension plans and health care plans be recognized.

First, pension benefits typically are determined according to a pre-determined formula, usually related to wages, which the employer is able to predict with some certainty. Health care expenditures, however, rise with very little ability of the employer to influence their rate of increase. Moreover, the rate of increase in recent years has been fluctuating between 7 and 15 percent annually. Regrettably, the prospect for double digit medical inflation is good. Vesting a retiree in a health plan in which the employer pays health costs regardless of their increase would be akin to vesting an individual in a pension plan with an unlimited cost-of-living adjustment.

Second, pension benefits typically start at the point the employee retires and continues until that person's death and then may be paid, at a reduced rate, to the retiree's surviving spouse. However, health plans do not operate that way. Full health benefits are generally provided to the employee and dependents from the time an individual starts working for an employer and continues through retirement even after Medicare becomes the primary payor. It frequently continues until the death of the retiree's spouse. In many instances, this represents a total period of fifty or sixty years.

Third, whereas pension benefit entitlements increase for each year an employee works, health benefits are not generally determined according to length of service. Generally, even relatively short-term employees qualify for full and costly health benefits.

Fourth, pension benefits for persons retiring early are actuarially reduced to reflect the increased period of payment. Health benefits are not. In fact, the opposite is true. For those retirees who retire before they are eligible for Medicare coverage, the employer's financial obligation for health coverage is greater than for those whose health coverage is a shared responsibility between the employer plan and Medicare.

Closely related to vesting of benefits is the concept of portability. Here, again, there are great distinctions between pension and health benefits. As difficult as it may be to establish a working mechanism for portable pension benefits, it is considerably more problematic for health benefits. For example, assuming that an individual could somehow be vested in a retiree health benefit and, in fact, became vested in two different employers' health plans during his or her working life, how would these multiple benefits be used? Would the retiree be entitled to duplicative health coverage from both plans? Partial coverage from each? Coverage from the first or the second employer only? The concept of portability simply is not as readily applicable to the health care context.

In short, a health benefit is a far different type of benefit than a pension benefit. Its design and purpose is considerably different and the ability of the employer to control its cost is markedly diminished. These distinctions must be taken into account in considering the application of ERISA-like standards to post-employment health plans.

OPTIONS FOR ADDRESSING THE RETIREE HEALTH BENEFITS CHALLENGE

In seeking options to encourage the private sector to provide and pay for post-employment health benefits, a few proposals deserve special consideration. As mentioned above, greater incentives for pre-funding benefits must be endorsed. Whereas a pay-as-you-go approach may have been appropriate when retiree health arrangements were in their infancy, the demographics of the population and the financial considerations of FASB requirements makes adequate advanced funding of these obligations an imperative for both the security of the employer and the retiree and his/her dependents.

The APPWP also recommends an additional method of helping to fund retiree health benefits. Presently, many employers are sponsors of defined benefit plans which have considerably more assets than are needed to satisfy pension benefit promises to the participants of those plans. Employers should be permitted to pay retiree health benefits directly from these pension trusts or to transfer these

surplus assets to retiree health plans, without adverse tax consequences, in order to fund retiree health obligations. Such transfers would permit these pension assets to be dedicated for other retiree benefit purposes. It is worth noting that such a transfer of surplus assets should be a revenue gaining change because funds for which employers have already taken a deduction would be used to pay health benefits, rather than forcing employers to take new deductions for pay-as-you-go health expenditures.

During the upcoming conference on Technical Corrections legislation (H.R. 4333 and S. 2238) the Ways & Means Committee and the Senate Finance Committee will be asked to consider a proposal, contained in the Senate bill, to increase from 10% to 60% the excise tax imposed on reversions from overfunded pension plans. We urge the conferees to reject that proposal not only because it represents bad pension policy but, also, because hasty action on reversion policy might undermine the opportunity for a thoughtful consideration of using surplus pension assets for funding retiree health benefits.

The APPWP also wishes to express its support for the direction of the proposed legislation that has been authored by Representative Rod Chandler to expand the funding options for post-employment health benefits. This proposal recognizes the seriousness of the problem facing retirees and employers and offers promising proposals to address the challenge. We look forward to the opportunity to provide more detailed comments on this proposal for the committee's future consideration.

CONCLUSION

The aging of the baby boom generation, continued growth of real health care costs and increasing pressure on the federal government to restrain the growth of Medicare expenditures will create greater pressure on employers to help ensure the financial health care protection of America's elderly through company sponsored health plans. Simultaneously, restrictions on employers' ability to adequately fund for these projected expenditures as well as requirements to reflect these unfunded liabilities on a company's balance sheet will diminish employers' interests in providing these benefits. Tax incentives, alone, may not be sufficient to encourage employers to assume the obligation for these benefits. However, without the proper mix of tax incentives, employers will almost certainly be unwilling and unable to help meet the important health policy objective of providing needed health care coverage for America's retiree population. The APPWP looks forward to the opportunity to work with the Congress toward creative solutions to this important and timely problem.

Chairman PICKLE. Thank you very much, Mr. Davey, for your statement.

Now, Mr. Gulotta.

STATEMENT OF MICHAEL J. GULOTTA, PRESIDENT AND CHIEF ACTUARY, ACTUARIAL SCIENCES ASSOCIATES, INC., ON BEHALF OF THE COALITION FOR RETIREMENT INCOME SECURITY

Mr. GULOTTA. Thank you, Mr. Chairman.

My name is Michael Gulotta, and I am president and chief actuary of Actuarial Sciences Associates, which is a wholly owned subsidiary of AT&T. Today, I am here on behalf of the Coalition for Retirement Income Security, which is an ad hoc group of large corporate sponsors of soundly funded pension plans.

The issue before us today is the single most critical social issue that is going to be facing America in the next two decades, that is, the delivery of medical care to a rapidly aging population. And as you have heard, there is a good deal of frustration surrounding the delivery of medical care to retirees.

It seems that, no matter how hard we try, we cannot control, we cannot get our hands around, increasing health care costs. And recently, although inflation has been at a reasonable level, we are still experiencing significant increases in the costs of providing medical care to our retirees.

Another cause for concern—and we have heard a lot about this today—derives from the expected release of an accounting standard by the FASB and what that is going to be doing to income statements and balance sheets of corporations.

The frustration also results from the fact that the obligations for postretirement health benefits to current and future retirees, if they were aggregated, represent an enormous sum. It would not surprise us if the aggregate liabilities of postretirement health benefits are in excess of $1 trillion. Unfortunately, these obligations are mostly unfunded.

It is a long way between where we stand today and where we need to be, between little, if any, security for postretirement benefits, that is, little if any assets accumulated for providing postretirement health benefits to soundly funded programs.

The coalition believes that the goal of retiree health benefits security is an attainable one and, in our view, there are two major elements in the strategy for achieving that goal. One is the ability to pre-fund, on a basis similar to pensions, for postretirement health benefits. A complementary and critical second element would be to permit the transfer of excess pension fund assets to protect the benefits of current retirees.

The coalition has focused on this latter element, since we believed it represents a major first step toward achieving the ultimate objectives, and we have a proposal. The 10 basic tenets of our proposal are as follows:

One, we believe that for purposes of transfer, excess pension fund assets should be determined on a basis which includes some cushion over the amount required for termination liabilities, that is, pension plan benefits upon termination.

Two, any asset transfer would be differentiated from an asset reversion in that the transfer would be free of income and excise tax.

Three, investment income on the assets transfered to a retiree medical trust should not be subject to income tax or unrelated business income tax.

Four, transferable assets would be limited tothe amount of unfunded medical liabilities for current retirees as of the date of the asset transfer.

Five, the initial decision to transfer excess pension fund assets should be a voluntary one and should be permitted at any time.

Six, assets transferred should be considered to be the first payor with respect to the employer's obligations for postretirement medical benefits.

Seven, to protect and to enhance the revenue impact, the proposal would call for the ability to use the assets transferred from one qualified plan to pay retiree health claims of retirees who are participants in other qualified plans maintained by the same sponsor.

Eight, transfers should be reflected as plan amendments for the purposes of minimum pension funding.

Nine, this is very important—the transfer of assets should be on an irrevocable basic, that is, the assets transferred from the pension fund must be used to pay postretirement medical benefits to retirees and under absolutely no circumstances could those transferred assets revert to the employer.

Ten, should the retiree medical plan be terminated, any funds remaining in that retiree medical trust would be applied to the purchase of postretirement benefits for the retirees at the time of termination.

Our proposal has the advantage of permanently and irrevocably allocating excess pension assets to providing retiree health benefits and thus protecting those assets against reversion to the current or any future plan sponsor. It has the added advantage of reducing the liability which would have to be shown on the balance sheet under the proposed accounting standard.

A third and very important advantage is that it would result in significant increases in tax revenues. Our proposal would result in significant increases in tax revenues. Based on a study performed by Price Waterhouse, tax revenues would increase by approximately $6.6 billion over the next 5 fiscal years under this proposal.

The coalition thanks the subcommittee for this opportunity to present our proposal, and it offers the subcommittee any information it may need in making this proposal a legislative reality.

Thank you.

[The statement of Mr. Gulotta follows:]

TESTIMONY OF MICHAEL J. GULOTTA
ON BEHALF OF THE
COALITION FOR RETIREMENT INCOME SECURITY
BEFORE THE OVERSIGHT COMMITTEE OF
THE HOUSE WAYS AND MEANS COMMITTEE
SEPTEMBER 15, 1988

Chairman Pickle and distinguished members of the Oversight Subcommittee, my name is Michael J. Gulotta. I am President and Chief Actuary of Actuarial Sciences Associates, which is a wholly-owned subsidiary of AT&T. Today I am here on behalf of the Coalition For Retirement Income Security. The Coalition is an ad hoc group of large corporate sponsors of soundly funded pension plans who are concerned with the retirement income security of the many millions of current and future retirees who have dedicated many years to the service of our companies. Participants include representatives of a wide variety of industries including oil, telecommunications, computers, chemicals and manufacturing. We would like to take this opportunity to commend this subcommittee for its work in 1987 in the development of the Pension Protection Act, an act which increased the security that American retirees will collect the pensions that were promised to them. Today the issue before us is not pensions. Indeed, from a number of points of view, pensions would be a simpler subject. The issue before us today is the single most critical social issue that is going to be facing America in the next two decades, that is, the delivery of medical care to a rapidly aging population.

There is a good deal of frustration today surrounding the delivery of medical care to retirees. That frustration is shared by corporations, by employees, and by the Congress alike. And there are some very good reasons for this frustration.

It seems that no matter how hard we try, we can't control, we can't get our hands around, increasing health care costs. Recently, even though inflation is at a reasonable level, we're still experiencing significant increases in the cost of providing medical care to our retirees. Another cause for concern derives from the expected release of an accounting standard by the Financial Accounting Standards Board. The FASB's direction is forcing corporations to put medical care delivery to retirees on an already crowded list of high-priority items that require speedy resolution. That proposed FASB standard is a threat to the corporations' balance sheet and income statement. There is no doubt that if the standard is finalized, it would significantly and adversely impact reported corporate earnings. In addition, large balance sheet liabilities would show up on corporate balance sheets.

The frustration I speak about also results from the fact that the obligations for post-retirement health benefits to current and future retirees, if they were aggregated, represent an enormous sum. While no one can say for certain what that single sum is, it would not surprise us if the aggregate liabilities for post-retirement health benefits are in excess of $1 trillion. Unfortunately, most of this $1 trillion is unfunded. That is, there is very little in the way of assets which support the obligations for retiree health benefits. Historically, companies focused on the funding of their pension plans. Health care costs for retiree benefits, particularly when expressed as a percentage of payroll, were not significant enough to worry about in the 1960s or even in the 1970s. Then, rapidly rising health care costs and the swelling of the retiree ranks quickly increased the annual amounts that companies were paying for retiree health benefits.

So here we are with large unfunded retiree health expenses. What we need is a rational and systematic approach to achieve post-retirement health benefit security. It's a long way between where we stand today and where we need to be; between little if any security for post-retirement benefits, little if any assets accumulated for providing post-retirement health benefits--to soundly funded programs.

The Coalition believes that the goal of retiree health benefit security is an attainable one. And, in our view, there are two major elements in the strategy for achieving that goal. One element is the ability to prefund on a basis similar to what is permitted under current tax law with regard to pensions for retirement health benefits. A complementary and critical second element would be to permit the transfer of excess pension fund assets to protect the benefits of current retirees.

The Coalition has focused on this latter element since we believe it represents a major first step, indeed, a head start, toward achieving the ultimate objective. The balance of my testimony will outline the Coalition's proposal to establish a base level of benefit security for retiree health benefits. Our proposal is a limited one dealing solely with the transfer of excess pension fund assets to protect the health benefits of retirees, and it does not address the broader issues of general prefunding of retiree health benefits or the vesting or accrual of retiree health benefits. The basic tenets of our proposal are as follows:

1. Excess pension assets should be determined on a basis which includes a cushion over the amount required for termination liabilities and should be available for voluntary transfer to a retiree medical trust to pay medical plan benefits for retirees.

2. Any asset transfer would be differentiated from an asset reversion in that the transfer would be free of income and excise tax. In addition, the asset transfer would not be treated in any way like a plan termination, and, thus, vesting or annuitization of active or retiree pension liabilities would not be required.

3. Investment income on assets transferred to a retiree medical trust would not be subject to income tax or unrelated business income tax. That is, they would be treated similar to pension plan assets.

4. Transferrable assets would be limited to the amount of unfunded medical liabilities for current retirees as of the date of the asset transfer. Determination of these medical liabilities should be on a realistic basis and should include a provision for expected medical care cost increases in the future.

5. The initial decision to transfer excess pension fund assets should be a voluntary one and should be permitted at any time.

6. Assets transferred should be considered to be the "first payor" with respect to employer obligations for retiree medical benefit payments. This approach, while establishing benefit security for current retirees, would also result in an increase in tax revenues.

7. To protect and to enhance the revenue impact, the proposal would call for the ability to use the assets transferred from one qualified pension plan to pay retiree health claims of retirees who are participants in other qualified pension plans maintained by the same sponsor.

8. Transfers should be reflected as plan amendments for the purposes of minimum and maximum pension funding rules.

9. The transfer of assets should be on an irrevocable basis, that is assets transferred from the pension fund must be used to pay post-retirement medical benefits to retirees, and, under absolutely no circumstances, could transferred assets revert to the employer.

10. Should the retiree medical plan be terminated, any funds remaining in the retiree medical trust would be applied to the purchase of post-retirement benefits for the retirees at the time of termination.

Our proposal represents a significant first step toward achieving benefit security for retiree health benefits. It has the advantage of permanently and irrevocably allocating excess pension assets to providing retiree health benefits and thus protecting such assets against reversion to the current or any future plan sponsor. The proposal has the added advantage, from a corporate financial point of view, of reducing the liability which would have to be shown on the balance sheet under the proposed accounting standard to be issued by the FASB.

A third and very important advantage of our proposal is that it would result in significant increases in tax revenues over the next 5 years. This derives from the fact that transferred assets would be the source of retiree benefit payments, and, thus, employers would not continue to take tax deductions for such payments. Based on a study funded by the Coalition and performed by Price Waterhouse, a large and prestigious accounting firm, tax revenues would increase by approximately $6.6 billion over the next 5 fiscal years. This revenue estimate was based on information provided by CRIS participants from their pension plans. CRIS participants sponsor pension plans whose assets comprise approximately 12.3% of all pension plan assets in this country. We believe that the revenue estimate is a credible one since it has been determined based upon statistically significant data.

What we have described here is a proposal which provides a foundation for benefit security. It's a first step. It does not solve the problem forever, but it takes advantage of the fact that better than expected investment performance over the last several years and generally responsible funding for pension obligations historically have combined to produce some surplus pension assets which can be put to productive use. So, at the same time that retirees gain by their benefit security being increased, corporations gain by their balance sheet liabilities being decreased, and, at least for the short term, the country gains an improvement in tax revenues.

The Coalition thanks the subcommittee for this opportunity to present our proposal and offers the subcommittee any information it may need in making this proposal a legislative reality.

Chairman PICKLE. Mr. Gulotta, let me ask you, you just got through saying that these proposed FASB accounting standards are a threat to corporate America's financial statements, and that this would cause great damage to them. I agree that publishing the liability under the FASB rules, assuming that is what they request, would show what the liability of a corporation is more or less, so I do not think there is any question about that.

How does it hurt the companies to actually show what their liability is on their corporate structure, on the corporate balance sheet?

Mr. GULOTTA. I do not think it hurts the company except to the extent that reported earnings per share are going to be reduced and significantly so, because we are talking about, on the average, a fourfold to fivefold increase in what is recorded as expense for postretirement benefits. So, earnings per share are going to drop and, to the extent that earnings per share are impaired, there is likely to be a move by corporations—and we have heard this from other panelists—to reduce the amount of future benefits. Maybe not current retirees and maybe not those who are eligible to retire, but future retirees, those active employees like me who are not eligible to retire, may have their health benefits reduced significantly so as to reduce the impact on earnings per share.

I think the FASB's proposal, while being a threat to the income statement, translates more realistically to a threat to the benefit levels that are going to be paid to future generations of retirees, in particular the baby-boomers.

Chairman PICKLE. Well, Mr. Gulotta, I keep asking myself how does the fact that, if FASB issued these standards, how does the fact that you accurately require a corporation to list its liabilities weaken the financial condition of that company?

Mr. GULOTTA. The corporation is going to revise its commitments, its future commitments for benefits—the liability that would be posted on the balance sheet or that would be reflected in the income statement and that would reduce earnings per share is not just the liability for current retirees. It is the liability for future retirees as well.

Chairman PICKLE. Of course it is, I would think it would be that way.

Mr. GULOTTA. So, what will happen is that a company is going to reduce its benefit commitments to those future retirees.

Chairman PICKLE. I am trying my best to understand why, if they say that this is a liability and that it should be reflected in the balance sheet, that this bothers you or that it would bother Mr. Ugoretz.

Mr. GULOTTA. Well, let me——

Chairman PICKLE. Mr. Ugoretz says that if you do that, you said in effect—let me see, if a company, was required to show its retiree benefits as a liability, that they are caught in a catch 22. If the company has to show that as a liability, but at the same time you are going to penalize them for being able to take any kind of tax writeoff.

Mr. UGORETZ. Let me move back a step——

Chairman PICKLE. How are we penalizing them?

Mr. UGORETZ. Let me move back a step, Mr. Chairman. If the company is faced with an increased liability on its balance sheet—and it depends on what it is that FASB does.

Chairman PICKLE. Well, you know what the argument is about.

Mr. UGORETZ. Now, if that company——

Chairman PICKLE. You assume what the argument is about in your statement. There is no real question about that.

Mr. UGORETZ. If the liability to a given company is very high, it affects corporate earnings, it affects the price of the company's stock, and it also affects that company's ability to borrow money——

Chairman PICKLE. How is it going to affect corporate earnings?

Mr. UGORETZ. It affects corporate earnings as they appear on the balance sheet because, if that liability is shown to be high, then earnings are offset, and the stock may become less valuable as well.

Chairman PICKLE. Well, are you saying we ought not to show it as a liability?

Mr. UGORETZ. Excuse me?

Chairman PICKLE. Do you think that it should not be shown on your books as a liability?

Mr. UGORETZ. I think it is going to depend very much on how FASB portrays the liability. That is very much up in the air. The real argument is not whether you put it on the books, but how it is that FASB requires you to do it and what it requires that you include. For example——

Chairman PICKLE. Let me ask you a question. You know how these things work better than we would. Suppose that FASB did issue these standards and suppose they are about as you fear they might be—we do not know, but let us say they are. Now you say that you are going to be damaged because you have to show it as a liability, that you will not be able to deduct it. Would you not be able to deduct expenses for the costs of your health retirement for the particular year that is involved, in 1989? If FASB issued the standard, you could still take the expenses for that year, could you not?

Mr. UGORETZ. You could still deduct current expenses for that year——

Chairman PICKLE. All right, so if you can do that, then are you not really——

Mr. UGORETZ [continuing]. But you would be faced with a substantial unfunded liability.

Chairman PICKLE. If you could do that, then, are you not really just saying we just do not want to show publicly, we do not have to admit it publicly?

Mr. UGORETZ. No, we already do that. Current expenses are often already footnoted.

Chairman PICKLE. Now, some companies may do that publicly, but I do not know, do you mean you already list that as a liability now?

Mr. UGORETZ. My understanding is that some companies at least footnote current expenses, although it is not——

Chairman PICKLE. Are you speaking for ERIC or are you speaking for the Fortune 500?

Mr. UGORETZ. I am speaking from my understanding of it.

Chairman PICKLE. If you show it as a liability, what is the argument? What is all this hearing about?

Mr. DAVEY. The question is that Congress has not determined whether or not these benefits are vested. They certainly did not do that in ERIA. Now, going back to the gentleman from Texas, that is the point he was making.

Chairman PICKLE. We may get into the vestment and we may get into ERISA requirements.

Mr. DAVEY. FASB, in its accounting rules, is in essence making the implication that these benefits are vested, and I suggest that should be a political decision made by Congress and not by FASB.

Chairman PICKLE. Again, I say it sounds like I am trying to argue with you, but I am trying to convince myself is it a good principle for a company to show the obligation. What is their liability in the field where they promised a payment or a benefit.

Mr. GULOTTA. Mr. Chairman, to the extent that a company does not change its commitment——

Chairman PICKLE. To the extent what?

Mr. GULOTTA. To the extent that a company does not change its benefit program in response to what the FASB is doing, then from a conceptual point of view—and this is my opinion, this is not the opinion of the organization that I am representing—the FASB's approach conceptually is correct and, you are right, the liability should be disclosed somewhere.

Mr. CHANDLER. Would you yield, Mr. Chairman?

Chairman PICKLE. I have trouble understanding your question.

I yield.

Mr. CHANDLER. If I worked for your company and you promised that you were going to pay whatever retiree health costs I had, then I expect you to do that, and you, the employer, would expect to pay it. FASB says—I just want to make sure you hear this—that if I am working for his company and he tells me that I am going to get a benefit when I retire, then I expect that. I believe think I have a right to expect that. It is part of my compensation, it is part of my bargaining agreement, it is part of why I worked for his company. So he expects to pay it, I expect to get it, and FASB says that, as long as you all have that agreement and as long as you have that expectation, you have a liability. It may not be vested, it may not be legal and may be terminatable, but there is a liability until something changes. Am I correct?

Mr. GULOTTA. That is correct, and the issuance of the statement is bringing the size of this liability to the attention of corporate America, and they are now looking at this problem and saying what are we going to do with this problem, what are we going to do with the size, how can we change the size of the liabilities, how can we control their increase.

A number of companies—we have heard that today—are thinking about changing their benefit programs so as to reduce the size of those liabilities. But I think the FASB is not the problem. The FASB points up that the problem exists. The problem is that, unlike pensions, we are sitting with these huge liabilities or huge obligations, unfunded expenses, and we do not have off-balance sheet assets to assure the payment of those benefits in the future,

regardless of future events including termination of the plan, bankruptcy, or takeover, or what have you. There are no assets backing up the promises that corporations have made, except the assets in the corporation itself.

Now, that may or may not be enough, but off-balance sheet assets would provide greater protection for the employees and would back up the promise. The proposal that I outlined would help back up the promise for current retirees. It uses excess pension fund assets to back up the promise.

Chairman PICKLE. I am mindful that you have made a proposal and I am glad you did and we are looking at it and we will look at it objectively. But I want to back up with you, when you said the problem is that FASB is going to issue these standards. The problem is not FASB, as I see it. The problem is that you companies have given retiree health benefits and you do not want to consider them as a liability. You have done it because, as Mr. Ugoretz says, it is good public policy, you can attract good employees and you can hold them, and it makes sense that you can do it.

It would seem to me, and I am just making this as a general statement, it just seems to me that we are better off if you believe in good accounting principles, to say to FASB, issue what you think makes good common sense, that is why you set them up, that is why they are in business. They are not set up in business to try to keep you from showing what is a liability and what is a loss and what is a profit. That is why you got it up, because it was set up by business primarily.

It would seem to me we would be better off to say, yes, everybody ought to agree that we ought to have good accounting principles. I do not know what proposal might be made, but whatever it is, we ought to be for accountability, and then let us look at it, what is the best way to go about handling the problem we have.

Some are saying it will wreck corporations. I have heard all kinds of reasons in the world why you do not really want to do it. I even heard it said that the reason you do not want corporate management to do it is you are going to show that their liability is one-third more and the value is one-third less, and that means that the profits and the bonuses of the big corporation attorneys and corporate executives will be less. We heard that. We have received that by way of comment by letter and calls.

Now, I do not make that statement at all, but I have heard a lot of reasons why, and for the life of me, I cannot understand why you would object to good accounting principles. I think that is all this committee would ask out of FASB. But when you say they are the problem, no, the problem is that you started something that is a little expensive and not it has gotten out of hand and you do not know how to handle it.

Mr. GULOTTA. But corporate America did not——

Chairman PICKLE. As I said, I do not want to argue with you, you understand.

Mr. GULOTTA. Mr. Chairman, you are correct, FASB is not the problem. You are correct, there ought to be good accounting standards and the FASB's conceptual approach to this problem is correct. However——

Chairman PICKLE. Let me ask Mr. Chandler to make a statement. This committee has got to be brought to a close because we have got another meeting in another 15 minutes and I regret that I cannot have this friendly discussion any longer, but we will resume it. There will be more.

Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman. I may have set a record today by attending the full day of a hearing for the first time in my legislative career, but it has been a fascinating one and I want to thank you for your attention to what I consider to be an important issue. If I could summarize what I believe I learned today, it is the fact that the proposed FASB rules which we are going to see this fall do not change anything. There is a liability there; it has been there all along; GAO says it is about $400 billion and that is huge by any standard when you look to American businesses trying to compete with the Japanese, the Germans, the Brazilians, and all those who have to pay it. The testimony consistently, over and over and over again, especially Mr. McMahon, who speaks Texan, said there is no vested liability. That is, these companies, at least for the current workers, can get out of paying this benefit if they want to.

Now, who is hurt by that—now, pay attention, because this is Democrat stuff—the people hurt will be middle- and low-income workers. I grew up with them, I pulled green chain along side of them, I hoed strawberries with them, and I know how devastating it could be to plan on this benefit and then not get it.

This is an egalitarian-type of benefit, unlike almost anything else we have seen. It evolved that way simply because of the nature of the benefit. The people who have this benefit enjoy a security, they enjoy and appreciate a dignity that it provides them in their retirement that other who do not have the benefit do not have. These are people who worked, they are workers who planned, and they are employers who meant to do the right thing.

You were right, Congress was not in on this decision at the time that it was made. That does not change the fact that we have a situation as it exists today. It is what we have to deal with, not what happened 20 years ago or anything else. The bill that Ronnie Flippo and I introduced today with, I might say, about eight cosponsors from the committee, may not be the total answer. NAM says there are elements of it that they do not like, labor has some problems here and there.

But the point I admire you for is the fact that you are pressing these people for answers and you want to know whether it makes sense to get into this business. I believe it does. I just want to say let us forget about all of this other stuff here and remember that these are people: people who are going to be hurt if we all do not do something—government, individuals and business working together.

Thank you, sir.

Chairman PICKLE. That is a fine statement, Mr. Chandler, and I appreciate your making it.

I do appreciate the testimony of the people who appeared today, all of you. I think the committee recognizes this as an enormous problem. We are going to have to face up to it and take care of it,

and I do not think we can do it by establishing fixed positions, although we may have sounded like it in some of the questioning here today. It is not because we have a fixed position, because I do not think we do. Mr. Chandler and Mr. Flippo have got their bill, but the committee is going to look at this broadly and try to find how is the best way to handle it, because it would be almost reprehensible if we said you have got to cancel all of these programs. Now, they have got a right to do that if they have to show this liability and do not want to do it. I would think that would be bad, as Mr. Chandler put his finger on it.

So, we have got to find out some way to make the system work. We will, but I do not think we are going to try to do it in the next fortnight. We will wrestle with it a little big longer, so we will be seeing you all again at a future time.

I do thank all of you for testifying today. The subcommittee is adjourned.

[Whereupon, at 3:45 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

WRITTEN STATEMENT OF THE
HEALTH INSURANCE ASSOCIATION
OF AMERICA
TO THE SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS

October 7, 1988

Issues Related to Employer Provided Retiree Health Insurance

The Health Insurance Association of America (HIAA) is the major national trade association for the commercial health insurance companies of America. Membership of the HIAA consists of approximately 350 health insurance companies, which provide approximately 80% of the commercial health insurance. Many HIAA member companies are actively involved in providing employers with health insurance for their retired employees. Also, many member companies, as an employer, provide health insurance benefits to their own retired employees.

Several factors affecting the finance of health care for the retired population make this issue a growing public policy concern for employers, insurers and legislators. Increases in the number and ages of retired workers, along with the continued rise of health care costs at a faster pace than general price inflation has resulted in the rapid growth of expenditures for retiree health care. These expenditures are straining the resources of both the public and private sectors.

In addition, Medicare cutbacks in the form of increased deductibles, greater copayments, changes in provider reimbursement limits and legislative initiatives mandating greater primacy and continuation of employer-sponsored coverage have increasingly shifted the burden of financing retiree health care to employers and to retired workers themselves. The recently enacted Medicare Catastrophic Act is not expected to significantly reverse this trend.

Funding for retiree health benefit costs has been complicated by the enactment of DEFRA. DEFRA imposed severe limitations on the ability of employers to fund their retiree health benefit obligations over the working life times of their employees. DEFRA discouraged the use of Voluntary Employee Benefit Association (VEBA) trusts and insurance contracts as tax advantaged ways to prefund retiree medical benefits.

Currently, about 98% of the retiree health benefits provided by employers are funded on a pay-as-you-go basis. However, accounting standards being developed by the Financial Accounting Standards Board (FASB) are expected to require employers to reflect the financial obligations for retiree health benefits on their balance sheets. A 1987 study by one member of the HIAA, Metropolitan Life Insurance Company, of the accrued liabilities of Fortune 500 Companies estimated the range of liabilities for current retirees from $111 to $348 billion dollars. The study estimated the range of the total liability for current and future retirees, plus dependent and surviving spouses, was from $236 to $591 billion dollars.

Obviously, employers are concerned about the impact of such liabilities on their balance sheets and earnings. This concern is exacerbated by court decisions on litigation involving efforts of employers to change benefits for retirees. Also, employers are concerned about anticipated legislative efforts to protect the rights of retirees by legislatively mandating benefits, funding, vesting and portability. These efforts are seen as unnecessary, expensive and administratively complex.

It is obvious the employer-sponsored retiree health care benefits issue has many dimensions. These include the role of the public and private sectors in financing retiree health care. In particular, what role should employers be required or encouraged to play? Also, how should coverage for retirees prior to their Medicare eligibility contrast with coverage that supplements Medicare after becoming eligible for Medicare? Should the focus for benefits for retirees be on acute care, or should greater attention be given to long term care? How can assurances be give that "promised" benefits by employers are delivered to current and future retirees?

At this time, the health insurance industry believes efforts should be focused on the role of employer-sponsored coverage of acute care benefits for pre-and post-65 retirees. In developing policy the following issues should be addressed:

- Tax treatment - What tax incentives should apply to: employer funding; employee funding; fund earnings; fund disbursements to pay medical costs? Should these incentives or penalties differ for the funding of current retirees as opposed to accruals for future retirees? Should the tax treatment be the same for active and retired employees? What penalties, if any, should apply to fund reversions to the employer?

- Benefit design - Should benefits be on a defined basis, such as specific dollar benefits for medical reimbursement, or a defined contribution approach, or a combination? Should benefit definitions differ for retirees not eligible for Medicare benefits? Given the current and anticipated continued cost inflation of health care, how can methods be retained to use cost containment provisions to manage the delivery of retiree health care?

- Vesting, accrual and portability considerations - Should active employees be vested in retiree health care coverage, and if so, at what point? At what rate, and on what basis, do benefits accrue? What is the nature of vesting and accrual for "defined benefit" health plans? How will benefit accrual earned by an employee with multiple employers be coordinated?

- Funding - What funding methods will be permitted? Over what time frame will existing "past service liabilities" be amoritized? Should minimum and/or maximum funding levels be mandated? What funding vehicles should be permissible: retired medical reserves; deposit annuity funds; 401(h) or 401(k) accounts; VEBA's, life insurance; individual medical accounts?

The health insurance industry believes there are many questions that need answers in regard to employer-sponsored retiree health benefits. Given the many unanswered questions and the potential impact of the FASB standards, employers will be hard pressed to plan for and control benefit expenses on a predictable and reasonable basis.

In view of the many dimensions of this complex employer issue, policy positions are still evolving. However, the HIAA proposes the following guidelines for consideration on employer-sponsored retiree health plans:

- Responsibility for providing health care benefits for retired employees should continue to be shared by the government, employers and employees.

- Medicare should remain as the primary medical program for the aged. Consequently, a stable government policy with respect to the Medicare program is essential.

- Retiree health care benefits offered by employers should be voluntary and employers should not be required to provide medical care benefits to retired employees beyond generally recognized and limited rights of continuation.

- Government policy should encourage voluntary provision of retiree coverage through tax incentives for prefunding of the benefits.

- Employer plans for retirees should be exempt from state mandates for benefits to facilitate coordination with Medicare in a consistent fashion.

- Employers should keep promises made to retired employees. However, employers should also have the right to change their benefit plans for future retirees.

- Benefits for employees should be adequately disclosed in understandable terms. This disclosure should consist of an explanation of the level of benefits provided and the degree of employer commitment of continuing the benefits.

The HIAA is encouraged by legislative proposals such as that of Representative Chandler, which incorporate concepts such as voluntary prefunding on a tax-preferred basis. Prefunding of retiree health benefits should be a positive step in the right direction toward resolution of a very complex issue. It is suggested Representative Chandler's proposal be broader in scope to allow uses of funding vehicles other than the pension trust specified, while still retaining the rules and controls desired. Other funding alternatives should be considered, such as individual medical accounts or VEBA's. Also, changes are suggested to Sections 419 and 512 of the IRS Code, which currently preclude an employer from prefunding retiree health benefits in a tax effective manner because investment income on the retiree health fund is subject to current taxation.

Employers of the nation who are providing retiree health benefits will be vigorously challenged to comply with the expected FASB standards and potential legislative proposals related to retiree health benefits. Given the dimensions of the issue, the complexity attached and the ever increasing cost to employers for providing health care benefits to both active and retired employers, proposals that provide flexibility and incentives are strongly encouraged. Some employers have already made significant changes in benefits or eligibility for benefits for future retirees. The incentives for employers to completely terminate such benefits should not be encouraged by proposals that do not provide flexibility and incentives.

Submitted on behalf of
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by
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**STATEMENT BY HOWARD J. JOHNSON, PRESIDENT,
HOWARD JOHNSON & COMPANY FOR THE
PRINTED RECORD OF THE
HEARING ON EMPLOYER-SPONSORED RETIRE HEALTH
INSURANCE
BY THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS**

The following comments are made for the consideration of the members of the Subcommittee on Oversight in connection with their review of employer-sponsored retiree health insurance. In this regard, we believe the members will wish to review 'legislation' which has been introduced to provide incentives for employers to finance such health coverage for retired employees.

These comments will specifically address the Bill introduced by Congressman Rod Chandler. Representative Chandler's Bill makes five major points and it is these ideas which are discussed below. The five points are:

- o Employers will be permitted to finance long-term care benefits, as well as health care benefits, for retired employees under pension plans;
- o Reversions of excess pension assets will be subject to a 100 percent excise tax unless the reversion is used to finance health care benefits and long-term care benefits for employees;
- o The Bill repeals the 150 percent full funding limitation enacted under OBRA '87;
- o Employers not maintaining a qualified retirement plan would be required to remit contributions to a simplified employee pension plan (SEP) for the employees who elect to defer compensation; and
- o Restrictions are placed on tax favored retirement plan distributions which will penalize lump sum distribution and encourage annuity benefits at retirement.

The following discusses each of the points in greater detail.

Financing Health Care and Long-Term Care

Representative Chandler's Bill permits pension and annuity plans to pay long-term care expense for retired employees in addition to the allowance of health care expenses for retired employees as currently permitted under the law.

In amending the law to provide for this authority, an employer is allowed to fund up to a stipulated amount without being required to demonstrate that the amounts funded for this reason are incidental to the pension benefit under the plan.

Under this authority, a defined benefit pension plan may fund an annual benefit at retirement of $5,000 (i.e., $2,500 for medical expenses and $2,500 for long-term care expenses). A defined contribution pension plan may annually contribute $1,650 for such expenses ($825 for each type of expense).

The amounts funded will represent a portion of the maximum retirement benefits which may be provided to an employee under the law. In other words, to the extent an employer funds either health care expense or long-term care expense, or both, under its pension plan, the employer will be prevented from funding the maximum retirement benefit for the employee. The maximum retirement benefit would be reduced by the amount of health care or long-term care expense funded.

In this regard, the Bill's provision to permit the funding of these expenses would not allow employers to contribute and deduct more than is currently allowed under the law. An Employer who wishes to fund a $5,000 additional defined benefit for his employees can do so under current pension law. **Therefore, it is submitted that the addition of this alternative will not represent an increase in the estimated amount of total tax expenditures devoted to the benefits area.**

This section of the proposed Bill also proposes to permit salary and wage deferral arrangements under a pension plan. This would allow employees to devote a portion or perhaps all, of their compensation deferral to funding a health or long-term care benefit. While the concept of encouraging employees to participate in the funding of these benefits is laudable, the rules currently applicable to 401(k) plans are very complex and we are concerned that extending these rules to pension plans under these circumstances would exacerbate the difficulty of administering these plans. Again, to the extent that employee deferrals for this purpose are included with those currently allowed for limit and discrimination purposes, we doubt that there would be a loss of tax revenue attributable to this provision.

100 Percent Tax on Reversions

The Bill would tax a reversion of excess pension assets to the employer at a rate of 100 percent of the reversion. A reversion which would be used to finance health care or long-term care expense would be exampt from this tax. A reversion would be permitted under these circumstances only if assets equal to at least 125 percent of the plan's termination liability continued in the plan.

It is believed that a 100 percent excise tax on pension asset reversions will not be effective and will not provide a significant incentive to employers to finance health care and long-term care expenses for retired employees. The current moderate tax on reversions will raise more revenue.

Under a 100 percent reversion tax, reversions will, in all likelihood, simply cease. An employer which would use excess pension assets to finance health care or long-term care expense would do so whether or not the 100 percent excise tax existed. Other employers will likely choose to increase pension bneefits to use the excess assets or will slow pension funding to match assets with liabilities.

An excise tax of such proportions would also tend to undermine the policy of adequately funded pension plans. Employers will be unwilling to fund their plans at a strong level if a 100 percent excise tax would apply to excess assets. As a result, it is believed that employers would provide minimal funding to pension plans in order to prevent excesses from occurring.

Repeal of the 150 Percent Funding Limit

It is believed that the OBRA '87 enactment of a 150 percent full funding limitation is not consistent with both the concept of sound funding principles as well as the concept of spreading funding over a time period in as nearly equal installments as possible. As a result, the repeal of this law is strongly endorsed.

The imposition of this rule had added substantial complexity to the funding of plans by requiring additional actuarial plan valuations. Also, the limitation is in conflict with the primary goal of adequately funded pension plans. The result is that directions at cross purposes are imposed on plans and the effect is that benefit security for employees is impaired. **This rule will also tend to cause greater potential liability for the Pension Benefit Guaranty Corporation by artificially limiting the full funding cap placed on plans.**

There is also general agreement among many actuaries that this limitation, in certain plans, has the effect of causing lower contributions in the early life of the plan and significantly higher contributions in the plan's later years. Such a result is, of course, not consistent with the sound actuarial methods which attempt to spread pension costs equally over years.

SEP Plans Allowing 401(k) Deferrals

The idea of permitting a wide range of employees to participate in a 401(k) arrangement is attractive. It is consistent with a sound policy of encouraging employees to save for their retirement. It also fosters the nation's objective of increased savings rates to bolster the growth of our economy and our competitive position in the world.

While these objectives could be furthered through allowing the establishment of 401(k) SEP arrangements by employers which do not maintain any other qualified plans, it is believed that such authority would have a long-term effect of undermining employer provided retirement benefits. This would result from the nature of a SEP arrangement which permits 401(k) deferrals.

By its terms, an employer may not exert any control over SEP. In addition, the SEP as allowed by the Bill would not permit any employer contributions. These aspects could cause employers to move in the direction of allowing only the SEP arrangement with the result that more and more of the responsibility for retirement benefits would fall on the employee. This, of course, would be inconsistent with a goal of encouraging employers to provide retirement benefits for employees.

It is also believed that any enactment of this type should be consistent with current rules applied to other tax favored arrangements. **The exemption from FICA and FUTA for the SEP deferrals would represent a significant departure from current law for similar arrangements and would appear to be a give-away that is not warranted.**

Distribution Restrictions

The Bill generally provides that distributions must be made as an annuity for life and penalizes violators by imposing a 20 percent excise tax on the distribution amount.

It is recognized that tax policy favors the accumulation of retirement funds for employees and for this reason, the distribution restrictions of the Bill are supported. This would have the effect of substa tially reducing lump sum distributions which are often taken early in a working career, and are not saved for retirement purposes.

In summary, it is believed that the primary problem facing us in connection with providing health care and long-term care expenses for retired employees is the ability of empoyers to finance these benefits. The cost of these benefits is recognized as an enormous liability which will be extremely difficult to finance. As a result, strong incentives should be provided to employers to assist them in establishing and funding benefits of this type for their employees. This Bill provides encouragement for employers to do so without reducing tax revenue.

U.S. SENATOR PATRICK LEAHY

VERMONT

Statement of Senator Patrick Leahy
Before the Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
September 15, 1988

Mr. Chairman:

Thank you for the opportunity to present my views on retiree health benefits. I commend you and the members of the Subcommittee for holding this hearing and for all the work you have done on this important issue.

The U.S. Department of Labor recently reported that American employers have underfunded their retiree health benefit plans by between $1 and $3 trillion. While this may not come as a surprise to members of the Subcommittee, I think workers in my State of Vermont and across the country will be shocked to learn that corporate America is running trillions of dollars short of being able to meet their obligations to their workers upon retirement.

The situation is serious and it is going to get worse unless we take action quickly. Workers are entitled to receive the retiree health benefits for which they have worked so hard. I believe that the only way out of this dangerous situation is a partnership between the public and private sectors.

That is why on Tuesday I introduced legislation, S. 2784, to provide a tax incentive for employers to set aside money now to meet their retiree health benefit obligations later.

The legislation I have introduced in the Senate and the companion bill introduced in the House by Congressman Daub will not provide all the answers but is a step in the right direction.

S. 2784 would remove the current $50,000 borrowing limit against Corporately Owned Life Insurance (COLI) for those employers who use such borrowing to fund retiree health benefit plans. The bill makes it clear that this new financing mechanism must be nondiscriminatory and provide benefits to all employees, regardless of whether they are rank-and-file workers or managers.

According to the Joint Committee on Taxation, my bill will cost the Treasury $24 million over five years. That is the government's contribution to the partnership.

The rest is up to the private sector. I was heartened to receive dozens of letters from major corporations with thousands of employees and retirees suggesting a willingness to take advantage of the new tax incentives proposed in S. 2784. Hopefully, this hearing and others like it will bring my proposal and others to the attention of American employers.

The time is fast approaching when Congress will have to deal in a meaningful way with the problem of underfunded retiree health benefit plans. Again, I commend the Committee for building a record, hopefully, for action by the next Congress to begin to address this important problem.

Thank you again, Mr. Chairman, for the opportunity to testify. With your permission, I would like to include a copy of my bill, as well as the revenue estimate provided by the Joint Committee on Taxation, in the record.

100TH CONGRESS, 1ST SESSION

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Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington, DC 20515-6453

DEC 3 1987

Honorable Patrick J. Leahy
United States Senate
Washington, DC 20510

Dear Senator Leahy:

This is in response to your request for a revenue estimate for a proposal relating to an exception to the present-law limits on the deductibility of interest paid by corporations on policyholder loans from life insurance contracts. Briefly, your proposal would exempt from the interest limitation those amounts incurred on indebtedness solely for the purpose of funding non-discriminatory retiree health and medical benefits.

We have estimated that your proposal would have the following effect on fiscal year budget receipts:

Fiscal Years (Millions of Dollars)				
1988	1989	1990	1991	1992
-2	-3	-5	-7	-7

I hope this information will be helpful to you. If we can be of any additional assistance in this matter, please let me know.

Sincerely,

David H. Brockway

S. 2784

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF INDEBTEDNESS INCURRED OR CONTINUED TO FUND POST-RETIREMENT MEDICAL BENEFITS

(a) IN GENERAL.—Section 264 of the Internal Revenue Code of 1986 (relating to certain amounts paid in connection with insurance contracts) is amended by adding at the end thereof the following new subsection:

"(d) INDEBTEDNESS FOR POST-RETIREMENT MEDICAL BENEFITS.—Subsection (a)(4) shall not apply to interest paid or accrued by the taxpayer during the taxable year on any indebtedness incurred or continued for the purpose of funding post-retirement medical benefits pursuant to a plan which meets the nondiscrimination requirements of section 505(b)."

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

September 15, 1988

COMMENTS OF ROBERT A. GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS FOR THE HOUSE WAYS AND MEANS COMMITTEE SUBCOMMITTEE ON OVERSIGHT HEARING ON EMPLOYER-SPONSORED RETIREE HEALTH INSURANCE

The National Coordinating Committee for Multiemployer Plans[1] shares the rising concern that current laws relating to and mechanisms for providing retiree health benefits are inadequate to meet the needs of retired and retiring American workers. These comments describe a proposal to help address this problem in multiemployer plans by permitting excess contributions to these plans to be used for essential retiree health benefits in some circumstances.

In general, this proposal would allow multiemployer pension plan trustees to transfer to a related multiemployer retiree health benefit plan all or part of current contributions, to the extent that such contributions exceed the minimum funding requirements of ERISA and the Code ("permissible amount").

Plans that transfer less than all of the permissible amount for a particular year under this proposal would be permitted to roll forward a "credit" equal to the difference between the permissible amount and the amount actually transferred for that year. For a future year, a plan would be permitted to transfer a maximum of the sum of these credits, plus the permissible amount for that year.

For example, consider a hypothetical plan having the following attributes:

1. Present value of total benefits equals $500 million.

2. Assets are valued at $400 million.

3. Funding standard account credit balance equals $100 million (i.e., contributions have exceeded minimum funding by $100 million).

4. Current contributions equal $40 million per year.

The amount that could be transferred for the current year under this proposal is $40 million. If the plan transferred only $10 million, it would have a $30 million credit to carry forward to subsequent plan years.

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[1] The NCCMP is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 190 pension and welfare plans, or their sponsors, and represents the interests of approximately nine million persons. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development -- legislative, administrative, and judicial -- of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

In the single employer plan context, it is already possible to achieve this result. An employer maintaining a health plan that needs money may simply reduce the contributions it would otherwise make to its pension plan, provided that minimum funding requirements are satisfied, and, instead, divert such contributions to the health plan.

Theoretically, this would also be possible, as a legal matter, in the multiemployer plan context. As a practical matter, however, the dynamics of the bargaining process and the fact that bargaining agreements run for a number of years, typically three, five, or more, make it impossible in many instances to divert pension plan contributions to retiree health benefit plans. In addition, because bargaining agreements under a plan are typically renegotiated with different employers at different times, it may be impossible to divert an adequate amount of funds to a retiree health benefit plan at any given time. The proposal described above simply provides a workable mechanism for accomplishing the result that is already available theoretically to multiemployer plans, and in fact available to single employer plans, under current law.

We look forward to discussing this important proposal with you and to working with you to develop and refine it further. If you have any questions, please call Vivian H. Berzinski of our professional staff at 872-8610.

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